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American Enterprise in the European Common Market: A Legal Profile. Volume 2.

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American Enterprise
in the
European Common Market
A Legal Profile

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American Enterprise in the European Common Market A Legal Profile

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Volume Two

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Chapter VIII

Organizing for Business

*Alfred F. Conard **

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INTRODUCTION

The emerging Common Market of Western Europe calls for new organization planning by many American enterprises. Many who have never before maintained a European organization will now develop one; and those who have long had European organizations will have to re-examine and revise them.

The subjects of planning—licenses to do business, liabilities of owners, taxation, management, finance—are the same in the Common Market as anywhere else. But there are many ways in which the European variables differ radically from those in the United States; there are others in which the variables in the Common Market will be found to differ significantly from those which prevailed in compartmented Europe.

In the following pages we will review some of the considerations which affect business organization in the European Economic Community, emphasizing the considerations which, on this new business frontier, are most different from corresponding considerations in the United States.

I. DOING BUSINESS FROM THE OUTSIDE (WITHOUT "ESTABLISHMENT")

Most of the present essay will be concerned with the organization of branches and subsidiaries in Europe. But branches and subsidiaries are not the only means of doing business in Europe; some of the largest exporters and importers may get along without them. These traders may do business with no one at all representing them in Europe; or with agents of various kinds who fall short of the "branch" category—who do not create, in the European term, an "establishment"¹ of the American company. In the next few pages we will indicate the principal considerations which might lead an enterprise to avoid creating a European "establishment," although doing business with Europe; we will also indicate by what means the enterprise could do business without "establishment."

A. FREEDOM OF ENTRY

I. PROVISIONS DIRECTED ESPECIALLY AGAINST FOREIGNERS

A good deal of attention is devoted in the Treaty of Rome and in current European discussion of it to the right of a national of one country to open a business establishment in another country on a plane of equality with the latter's own nationals. A good deal of this discussion is of very minor importance to Americans, because it concerns the right of *individuals* to live and work in the second country—a matter which Americans associate with the word "immigration." Among the European countries, the right of an individual Dutchman to operate a machine shop in Antwerp, or of an individual Italian to operate a tailor shop in Paris presents very important questions of economic and political policy.

The interest of American enterprises in the Common Market is generally of a different kind. They do not seek primarily to employ American citizens in Europe, but to employ American processes, products, trade names, and money. Although they would often like

¹ Although this word is not common as a legal term in American domestic law, it has long been used in the English language version of treaties of "Friendship, Commerce, and Navigation." See Walker, *Modern Treaties of Friendship, Commerce, and Navigation*, 42 MINN. L. REV. 805 (1958). It appears in the title of the recently concluded "Convention on Establishment" with France, November 25, 1959, 41 DEP'T STATE BULL. 829. The corresponding European terms are *établissement*, *Niederlassung*, *stabilimento*, and *vestiging*.

to use a few Americans as resident executives or technicians in their foreign subsidiaries, they can usually manage without.

We will notice briefly the rights of individual foreigners to conduct or work in a business in European countries, even though this is not a matter of primary concern. In France and Belgium foreign individuals must obtain a license to do business as permanent residents, called a *carte de commerçant étranger*.² These are said to be fairly easily obtained in France (although one must wait a few months and wheedle a few officials), but traditionally difficult to obtain in Belgium. In France, Americans can probably demand the eventual issue of the *carte* under the terms of the newly signed Convention of Establishment between the two countries,³ but the right which this treaty creates will probably not cause the *carte* to pass through official channels any faster than it did before.

The Convention of Establishment lists only the following lines of business, in which Americans shall not have the same rights as Frenchmen to do business in France:

Communications

Air or water transport

Banking involving depository or fiduciary functions

Exploitation of the soil or other natural resources

Production of electricity⁴

The Convention presumably supersedes the earlier French law which purported to admit Americans to exercise private rights to the same extent as the United States offers similar right to Frenchmen,⁵ with a limited number of exceptions.^{5a}

Three other countries of the Market—Germany, Italy, and the Netherlands, apparently have no rules affecting foreign individuals differently from nationals in the matter of access to commerce,

² *Le droit d'Etablissement dans le Marché Commun*, [1958] JOURNAL OFFICIEL DE LA REPUBLIQUE FRANÇAISE 999, 1004-1007 (1959).

³ Convention of Establishment with France, art. II, 41 DEP'T STATE BULL. 829 (1959). The treaty was signed on November 25, 1959, but has not been ratified at this writing.

⁴ *Id.* art V, para. 2. There is also a provision reserving the right to special regulation of trade in gold and silver, fissionable materials, armaments, and anything else affecting national security (art. XII).

⁵ France: C. Civ. art. 11. There is a similar provision in Italy: CODICE CIVILE, Disposizioni sulla Legge in Generale art. 16.

^{5a} RIPERT, TRAITÉ ÉLÉMENTAIRE DE DROIT COMMERCIAL (4th ed., 1959) 115, lists the following businesses from which foreigners are specifically excluded: ownership of French ships, of river boats, or of aircraft, hydro-electric power generation, public utilities, highway transport, sale of beverages, travel agencies, and munitions. There are also special restrictions on foreign activities in banking, brokerage, and itinerant merchandising.

except that Italy has a reciprocity provision.⁶ If these countries should adopt discriminatory provisions, they would be inapplicable to Americans because of the treaties of Commerce, Friendship and Navigation ("C.F.N. treaties") subsisting between them and the United States.⁷ All three treaties, like the U.S.-French Convention of Establishment, guarantee American individuals the same rights as nationals to carry on businesses in the respective countries. The German and Netherlands treaties contain exceptions similar to those in France,⁸ but the Italian treaty makes no such exceptions.

When we turn from the rights of individual Americans to live and work in European countries, and look at the rights of American corporations, we find that they have no less rights than individuals. The C.F.N. treaties give American companies as well as American individuals rights to establish branches and carry on commerce, with the same exceptions for key industries. With Belgium and Luxembourg, the United States has no C.F.N. treaties, but these countries do not attempt to discriminate against foreign enterprise.

If the problem of a license to do business proves troublesome in spite of the rights conferred by treaties between the European Country involved and the United States, there are other treaties affecting the right of establishment which may prove helpful. The three countries of the Benelux union are bound by treaty to admit the enterprises of each other. Therefore, if an American enterprise succeeds in establishing a bona fide subsidiary in one of those three countries, it is entitled to do business in the others. Further, Belgium and Luxembourg have made treaties of Friendship, Commerce, and Navigation with France, so that an entry into France may serve as a means of entry to Belgium or Luxembourg, and *vice versa*, subject to enumerated exceptions of a few particular lines of business.⁹

Further possibilities of entering one country through another

⁶ *Op. cit. supra*, notes 2, 5.

⁷ Germany: Treaty of Friendship, Commerce, and Navigation with the Federal Republic of Germany, Oct. 29, 1954, U.S. Dep't of State, Treaties and Other International Agreements Series (hereinafter cited as T.I.A.S.) No. 3593.

Italy: Treaty of Friendship, Commerce, and Navigation with the Italian Republic, Feb. 2, 1948, T.I.A.S. No. 1965.

Netherlands: Treaty of Friendship, Commerce, and Navigation with the Netherlands, March 27, 1956, T.I.A.S. No. 3942.

The press has reported that a treaty on the same subject is under negotiation with Belgium.

⁸ One exception in the French treaty—production of electric energy—does not appear in the German and Netherlands treaties, but the others appear in Article VII of both treaties.

⁹ *Op. cit. supra* note 2, at 1006.

arise from the terms of the Treaty of Rome, which created the Common Market. The Council of the Economic Community is enjoined by the Treaty of Rome to "lay down a general program for the abolition of restrictions existing within the Community on freedom of establishment" before the end of the first transitory stage—that is, before 1962.¹⁰ At the beginning of the second stage (supposedly 1962) the Council will have power to order abolition by majority vote.

The rights which the Council may grant, under the Rome Treaty, to companies of other Community countries cannot be denied merely because the companies are owned by Americans (or other outsiders). A company which is organized under Belgian law, managed in Belgium, and has its biggest plant there, *must* be treated by France as a Belgian national, for purposes of "establishment."¹¹ A literal reading of the Treaty suggests that any *one* of these three features would give the company Belgian rights, but a leading French commentator has challenged this interpretation.¹² Hence we do not think it is safe to assume that one can gain any formal advantage out of merely filing corporation papers in Luxembourg, as Americans do in Delaware.¹³ But a company with its true principal office and operational base in one country is sure of the right to set up an establishment in the others under the terms of the directives on establishment which the Community Council may issue.

We conclude that laws which discriminate against Americans in the matter of business licensing present a surmountable problem, or none at all, outside of a limited group of businesses in most of which American corporations are unlikely to be interested. This is not to say that Americans will not encounter discrimination, but merely that the important discrimination will not be in the form of a law requiring special permission for foreign business enterprises. One of the other obstacles may be, in France and Belgium, a law on the licensing of American individuals to be company executives.¹⁴ More serious obstacles will be presented by the laws on exchange of cur-

¹⁰ Treaty Establishing the European Economic Community [hereinafter cited as the Treaty] art. 54(1).

¹¹ The Treaty art. 58.

¹² Loussouarn, *Droit International du Commerce*, 12 REVUE TRIMESTRIELLE DE DROIT COMMERCIAL 246, 250 (1959).

¹³ Article 58 of the Treaty invites some speculation as to whether national rights can be obtained by maintaining a mere "registered office"; this question is examined by Mr. Thomas L. Nicholson in another chapter of this book.

¹⁴ Discussed later, in the sub-chapter on "Management."

rency; they do not discriminate against American companies, but only against American dollars.¹⁵ Although the victim of the discrimination may be the same, the means of dealing with the discrimination may be quite different. Finally, there is the obstacle of laws on business licensing which in terms apply equally to citizens and to foreigners, but which may be administered to discriminate in fact against foreigners. These non-discriminatory licensing laws will be next discussed.

2. DOMESTIC LICENSING PROVISIONS

When an American enterprise surmounts the hurdle of foreign nationality, it has only scratched the surface of the problem of establishing itself in Europe. It must still cut through the mass of licensing requirements which apply equally to locally owned enterprises. In Luxembourg and the Netherlands every business establishment must be licensed, whether foreign or domestic. In Italy, a permit is required for every retail trade, but not for manufacturing or (apparently) wholesale commerce. In Germany, access to manufacturing and wholesale trades is free, but every retail establishment requires a license. In France, entry into commerce is theoretically free, but there are a host of kinds of business for which licenses are required; a recent study reported the following list, which was not claimed to be complete, of products in which dealers must be licensed by one authority or another:

- Matches, arms, and explosives
- Drugs
- Gas generating equipment
- Transportation
- Amusements and spectacles
- Meat, milk, livestock, fish
- Bakery goods
- Wines

In addition, the following enterprises must be licensed, regardless of products:

- General stores
- Single-price stores (comparable to "5 and 10 cent stores")
- Stores specializing in close-outs
- Brokerage of several kinds—*e.g.*, stock, foreign exchange, and ships

¹⁵ Discussed later, in the sub-chapter on "Financing," and also in the separate chapter by M. Fernand Jeantet, under the title "Exchange Control Regulations in France."

Belgium is apparently the country with the greatest freedom of commerce; but licenses are required for dealing in transportation and in certain agricultural products,¹⁶ and a recent law requires proof of professional qualifications in all forms of "small business."¹⁷

Our information on how and why licenses are granted and refused in European countries is very indefinite—as it would be with respect to the United States, and for the same reasons. Lack of technical and financial qualifications will doubtless impede licensing, but they will rarely be the only impediments. Many of the French laws, at least, have added to technical requirements a condition that the proposed establishment should be in "the interest of the national or regional economy." Probably this question would be answered chiefly by reference to national and regional economic plans, either published or nascent. Our French collaborator, Professor Houin, warns that there is no effective judicial remedy against administrative discretion in denying the license for a foreign "merchant" which an American or other foreigner needs to serve as executive of a company or branch in France.

In Italy, the existence of factors other than technical ones is suggested by the membership of the committees which pass on retail licenses; they consist of the mayor, two local merchants, and two local laborers. Although an appeal from the committee's denial lies to an administrative court, the views of competing local interests are likely to color the final decisions.

In the Netherlands, the licensing process involves the advice of nation-wide trade associations which might be expected to view dimly any competition with their own products. There are also reported to be in the Netherlands very widespread "tying agreements," whereby all kinds of concerns engage to buy from only certain sources, which in turn agree to sell only to certain outlets. Thus there is a closed merchandising circuit, in which a newcomer can penetrate only with the consent of the trade associations.

From these fragmentary observations, it is evident that entry into the European market raises very complex problems. Entry is likely to prove extremely difficult in businesses, like the retail trade, in which a large number of local merchants fear new and powerful competition, but quite easy in certain manufacturing industries,

¹⁶ This and most of the preceding statements on "domestic licensing provisions" are based on *Le Droit d'Etablissement*, *op. cit. supra* note 2, at 999, 1004.

¹⁷ *Loi permettant d'instituer des conditions d'exercice de la profession dans les entreprises de l'artisanat du petit et du moyen commerce et de la petite industrie*, 24 Dec. 1958, 1959 Recueil des Lois et Arrêts Royaux de Belgique 108.

where the new products may be exported to compete elsewhere, or where they replace products which were primarily imported before.

None of these impediments to market entry—which apply in theory to local enterprise as well as to American—will be automatically eliminated by the Treaty of Rome, or by treaties of friendship, commerce, and navigation with the United States. These treaties exclude only discrimination against foreigners.

The exclusive agreements between manufacturers and distributors which obstruct entry of newcomers into the market may be contrary to the general principles enunciated in Article 85 of the Treaty.¹⁸ But these principles, like those of American antitrust law, are subject to widely varying interpretations. For the time being, their enforcement depends on the initiative of the Member States, none of which have much prior experience with “antitrust” law. In view of the persistence of trade restraints in the United States 70 years after the Sherman Act, and the traditional stability of distribution patterns in Europe, we would guess that many years will pass before actual penetration of European distribution systems becomes easy.

B. STAGES OF ENTRY

To speak of doing business with Europe from the outside is, of course, a mere metaphor. An enterprise which does any business at all with Europe becomes in some degree involved in European legal problems. To examine our problem more closely we will look at the problem of entering Europe as a problem of a timid bather getting into the swim—he may stand on the shore throwing pebbles, he may dip in his toes, he may wade, he may swim with his head out, or he may take a deep dive. Each stage of immersion involves exposure to added risks, and so does each stage of entry in the European market. We will therefore look at the various degrees to which an

¹⁸ The Treaty Article 85 condemns agreements and practices which consist in— (a) the direct or indirect fixing of purchase or selling prices or of any other trading conditions; (b) the limitation or control of production, markets, technical development or investment; (c) market-sharing or the sharing of sources of supply; (d) the application to parties to transactions of unequal terms in respect of equivalent supplies, thereby placing them at a competitive disadvantage; or (e) the subjecting of the conclusion of a contract to the acceptance by a party of additional supplies which, either by their nature or according to commercial usage, have no connection with the subject of such contract.

But the general condemnation is subject to an exception for agreement and practices which do not “eliminate competition in respect of a substantial proportion of the goods concerned,” and which “contribute to the improvement of the production or distribution of goods or to the promotion of technical or economic progress while reserving to users an equitable share of the profits resulting therefrom.”

American enterprise may enter the European Economic Community, and note some of the legal involvements which attach to each stage of entry.

The stages of entry must be carefully distinguished, because entry for one purpose may not be entry for another. "Establishment" is primarily a conception of commercial law; when an enterprise is "established" by commercial law standards, it is required to file and publish documents regarding its legal structure and its officers, and to enter its name in the commercial register.

However, an enterprise which is "established" for purposes of commercial law is not necessarily established for purposes of tax law. The double-taxation treaties which bind most of the Common Market countries to the United States have greatly restricted the tax concept of establishment; it is now distinctly different from the commercial law concept.

Because of these differences, we will consider the stages of entry into the European market from three different points of view—commercial licensing and registration, tax liability, and liability to suits in European courts. These three incidents may serve to illustrate the host of others which time and space forbid us to examine. Some of the other incidents—involving labor relations, restraints of competition and exchange control—are examined by the authors of other chapters of this book.

I. NO FOREIGN ASSETS

To separate itself as completely as possible from European entanglements an American enterprise may assure itself that it has no assets, tangible or intangible, in Europe. It may, that is, sell only by delivery at U.S. ports, and for payment in U.S. dollars on delivery. Clearly such a company need give no thought to European tax laws or European commercial status. European duties and exchange restrictions may worry the company's European customers, but not the company itself.

Oddly enough, the company might even then be sued in some European courts. European courts do not generally condition jurisdiction on the "presence" of the defendant, as common law courts do. In France and Luxembourg, the codes expressly provide that suit may be brought against a non-resident defendant for contracts undertaken outside the country; all that is needed is that the plaintiff should be a local resident.¹⁹ Italy is only a little stricter, requiring

¹⁹ France: C. Civ. art. 14.

that the obligation sued on should have been made, or should be due to be performed, in the country.²⁰

Fortunately for American enterprises, suits maintained against a company under such circumstances may do it little harm. If there are no assets in the country where the judgment is rendered, the judgment cannot be executed there. If the plaintiff tries to sue on his judgment in America, he will find that American courts consider it unenforceable for lack of jurisdiction.²¹ Even in Europe, the very countries which grant such judgments refuse to give effect to similar judgments rendered in other countries with similar laws; such judgments are said to be nationally valid, but internationally invalid.²²

2. EFFECTS OF FOREIGN ASSETS

The no-asset system may have merit for avoiding European entanglements, but it is not the best way to build up foreign business. Most enterprises will find that, if they want to make money, they cannot help acquiring foreign assets such as accounts receivable and balances in the hands of agents.

Assets abroad, whether tangible or intangible, large or small, will not subject the American owner to European income taxes. Neither do they involve commercial licensing and registration. But they expose the owner to effective suits in European courts. If the defendant has assets in the jurisdiction, he may be sued whether present or not, and the judgment may be executed on the assets that are present. This means that when a company acquires foreign assets, it may be compelled to defend abroad suits arising out of its business, or else abandon the assets.

This liability can be considerably reduced, if the company desires, by employing contract clauses providing for litigation at some other reasonable point, such as the state of the American company's home office. Such clauses are honored generally in Belgium, France, Germany, Luxembourg, and the Netherlands, but not in Italy.²³ Whether

²⁰ CODICE DI PROCEDURA CIVILE art. 4(2).

²¹ RESTATEMENT, CONFLICT OF LAWS, §§ 77, 429-430 (1934).

²² As to France, see BATIFFOL, TRAITÉ ÉLÉMENTAIRE DE DROIT INTERNATIONAL PRIVÉ 836 (1955).

²³ *Id.* at 763-64.

Luxembourg: Our Luxembourg collaborator, Mr. Arendt, calls attention to an exception affecting patents and trademarks. The filing of a patent or trademark in Luxembourg constitutes a consent to litigation affecting the patent or copyright. This consent will prevail over a contract providing for exclusive jurisdiction somewhere else.

they will scare away more business than they are worth we cannot say.

In addition to the possibility of being sued in Europe, a company which has assets there must consider the possibility of having to bring suit there. If it has assets, it may have to protect them. Receivables in particular must sometimes be collected by suit; patents, processes, and trademarks require constant legal protection. Since European laws and procedures are quite different from American, American enterprise will have to rely on European legal counsel. The possibility of having to find and retain such counsel, if the assets are not to be lost, must be reckoned among the costs of owning them.

3. EMPLOYEES IN EUROPE

In the six countries of the European Community a distinction is drawn, much more sharply than in American law, between "salaried personnel" and "commission agents." As their names suggest, they are commonly differentiated by receiving (on the one hand) a regular weekly or monthly wage, or (on the other hand) a commission based purely on the amount of business transacted. But there are usually more fundamental differences. The salaried personnel are normally full-time employees of the enterprise, owing an undivided loyalty to it alone, and receiving instructions from its management; the "commission agent" is normally free to represent various clients, and chooses his own hours and his own ways of soliciting customers. We will not speculate on the legal status of representatives who fall between the stools; to employ such persons would be to invite juridical uncertainty. We will explore the results of employing persons who fall clearly in one category or the other; and we will start with salaried personnel.

a. *Liability to Suit*

The mere presence of employees will make no difference in the suability of the employing company unless they hold general powers of attorney to make contracts in the company's name. This conclusion, perhaps surprising to Americans, follows from the fact that European courts do not base their conceptions of jurisdiction on "presence" of the defendant. However, the presence of employees will probably result in increasing the probabilities of suit. Employees in Europe will probably make more contracts with Europeans, and commit more torts against Europeans, than employees in the United States; and so the probabilities of European litigation will increase.

b. *Liability to Commercial Regulation*

The presence of employees will affect the incidence of commercial regulations in varying ways, depending on the permanence of the employees' stay, and the extent of their powers. We can say broadly that the *temporary* presence of employees, even though they come exclusively on business, will not in itself subject the company to European commercial licensing or registration. What is "temporary" is not easily defined, but the periods for which an American may reside as a tourist without visa—usually about three months—offer a general guide.

The consequence of employees' residing more permanently in Europe are viewed differently by our different informants. Professor Houin, speaking for France, observes, "It is hard to see how a company could have salaried personnel permanently in France and in charge of the company's affairs without having a French establishment; a physical place of business is not the test of establishment." His conclusion is that a company with employees in France—beyond the duration of tourist visas—is obliged to register itself as "established" in France. Our Belgian and German informants, on the other hand, do not see any commercial problem in the employees' presence if they do not have powers of contracting for the company. It would appear that in the latter countries permanent representatives could furnish information on products, especially technical information, and could supply maintenance service (without remuneration from customers) without commercially registering the company. Probably they could do so even in France if the evidence were sufficiently clear that that was all they were doing.

Commercial regulation becomes important when contractual negotiation—buying, selling, or licensing—is carried on by employees on a continuing basis. Our collaborators indicate that commercial qualification is definitely not required for casual and occasional representation; but it may be when a continuous practice of dealing develops.

What is "dealing," for this purpose? Professor Heenen advises that it does *not* include (in Belgium) giving and receiving information, even though this may be done through a fixed office; but it does include signing of contracts, even though all agreements are subject to confirmation in New York.

And when is it "continuous"? Professor Serick warns that trans-

actions in Germany may result in an "establishment" when they are designed to create an enduring source of income over a long period; this might include negotiations for patent licensing, even though no more transactions will take place in Germany after the initial one.

In summary, we think that a company may safely send its employees to Europe for short visits and even let them sell or buy for it there in transactions having no long-term aspects. It may keep employees indefinitely in Europe to display wares and give technical information and advice on its products. But if it has employees residing in Europe, and if they negotiate contracts, it probably needs to license and register itself (or a subsidiary) as the place where the employees maintain their center of activities.

c. Liability to Taxes on Income and Capital

For tax purposes, the question of what constitutes establishment is governed in five of the six countries of the Common Market by tax treaties with the United States.²⁴ These treaties are very favorable, and take a much more tolerant view of what activities can be carried on without "establishment" than does the commercial law. The one country which has not ratified a U.S. tax treaty is Luxembourg. The failure to ratify the treaty is not generally ascribed to any desire to tax American enterprises but to an unwillingness to exchange with the U.S. Treasury information on tax evaders. Luxembourg's non-ratification is therefore due to an excess of cordiality to foreign enterprise, rather than to any tax-hunger. It is safe to assume that Luxembourg will not impose taxes in circumstances in which neighboring countries would not.

All the tax treaties contain specific language which preclude the levying of taxes on the enterprise merely because of the presence of agents. The Belgian treaty, which is fairly representative, pro-

²⁴ Convention with Belgium for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income, (hereinafter cited as Treaty with Belgium) October 28, 1948, 4 U.S.T. & O.I.A. 1647, 173 U.N. Treaty Series 67.

Convention and protocol with the French Republic respecting double taxation, (hereinafter cited as Treaty with France) July 25, 1939, 59 U.S. Stat. 893, 125 U.N.T.S. 259.

Convention with the Federal Republic of Germany for the avoidance of double taxation (hereinafter cited as Treaty with Germany), July 22, 1954, 5 U.S.T. & O.I.A. 2768.

Convention with the Italian Republic for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income (hereinafter cited as Treaty with Italy), March 30, 1955, 7 U.S.T. & O.I.A. 2999.

Convention with the Kingdom of the Netherlands with respect to taxes on income and certain other taxes (hereinafter cited as Treaty with the Netherlands), April 29, 1948, 62 U.S. Stat. 1757.

vides that a "permanent establishment . . . does not include an agency unless the agent has, and habitually exercises, a general authority to negotiate and conclude contracts on behalf of such enterprise, or has a control over a stock of merchandise from which he regularly fulfills orders on behalf of such enterprise."²⁵ Thus it appears that an agency may fall short of being an establishment for tax purposes even though it would be deemed an establishment under the laws relating to licensing of foreign enterprises and registration of all commercial businesses.

Purchasing enjoys a special status under the tax treaties with five of the Common Market countries. All these treaties provide that an agency shall not be considered an establishment (for tax purposes) if its activities consist only of purchasing. Of course this clause grants no exemption from the requirements of commercial licensing and registration.

4. THE COMMISSION MERCHANT

The six nations of the E.E.C. possess a well defined commercial institution which is remarkably adapted to the needs of a foreign enterprise which wants to do business in the community. This is the commission merchant or commission agent, known in various European languages as *commissionnaire*, *Kommissionär*, *commissionario*, and *commissionnair*.

As his name suggests, the commission merchant is normally paid primarily in proportion to the business that he transacts. In addition—and this is perhaps the most important legal characteristic—he does business in his own name. For this reason, he is sometimes compared by legal writers with the American "agent for an undisclosed principal." The comparison is valid, but must not be understood as indicating that the commission merchant is concealing the person for whose account he buys and sells. The important point is that his letters and his invoices bear his own name, not the principal's; and in his dealing with third persons, he says, "I will sell you," not, "My principal will sell you." In addition to these characteristics, the commission merchant is described by European lawyers as one who is in the business of representing several clients and conducting his business according to his own independent ideas, rather than under the direction and control of a single enterprise.

With a European commission merchant an American enterprise

²⁵ Treaty with Belgium art. II(1). The law of Luxembourg, with which the U.S. has no tax treaty, is similar. Einkommensteuergesetz art. 49(2).

can be continuously and conspicuously represented in Europe without incurring any more legal burdens than the firm which sits in New York waiting for Europeans to come and buy. The American enterprise is not liable, under prevailing European legal doctrine, for the contracts which the commission merchant makes (in his own name) on the American concern's behalf. This is one of the celebrated contrasts between European and Anglo-American law relating to undisclosed principals.²⁶ A recent essay of Dean Hamel (of the Paris Law Faculty) casts some doubt on the future of this doctrine in France;²⁷ but in Germany and Italy the rule is firmly entrenched in an express provision of the Civil Code.²⁸

For purposes of commercial licensing and registration, it is clear that the commission merchant insulates the principal under European law. The commission merchant must be registered as a merchant, but the principal need not be. Being a local resident, the commission merchant will not need the special license which the foreign enterprise would require; but if any licenses are required, the commission merchant is the one to hold them. For purposes of exchange control the commission merchant is local, the principal foreign.

For tax purposes the status of the commission merchant and his principal are equally clear. Each of the five double-taxation treaties²⁹ provides specifically that a "bona fide commission agent" shall not constitute an "establishment of the enterprise which employs him."

There is one important danger in connection with the commission merchant. The employer may wish to switch from one commission merchant to another; or, becoming more deeply interested in the European market, may wish to supplant the commission merchant with a branch or subsidiary which will be under more complete control. Even though the commission merchant has been promised no specific tenure, the interruption of his profitable business, without

²⁶ Müller-Freienfels, *The Undisclosed Principal*, 16 MODERN LAW REVIEW 299 (1953); *Id. Comparative Aspects of Undisclosed Agency*, 18 MODERN LAW REVIEW 33 (1955); Jambu-Merlin, *Le Droit Comparé et les Conflits de Lois en Matière de Commission*, in HAMEL ET AL., *LE CONTRAT DE COMMISSION* 309 (1949).

²⁷ HAMEL, *LE CONTRAT DE COMMISSION* 16 (1949).

²⁸ Germany: BGB § 164(2).

Italy: CODICE CIVILE art. 1705. Our Italian collaborator, Mr. Bruna, calls attention to a qualification which may also apply elsewhere. If the undisclosed agent is in charge of a business establishment that belongs to the undisclosed principal, he may be regarded not as a "commission merchant" but as an *istitore*, and may render the principal liable even by a contract in the agent's name. CODICE CIVILE art. 2208.

²⁹ Note 24 *supra*.

good cause or reasonable notice, entitles him to be paid damages equal to his prospective profits.

Fortunately, this danger can generally be excluded by contract; the initial contract may provide for termination of the representation without damages. This provision will be honored in all of the Common Market countries except France.³⁰ In this respect, a commission merchant differs from a salaried employee, whose right to severance benefits is generally a matter of public policy which cannot be modified by private contract.

5. A BUSINESS OFFICE

Can an American enterprise maintain a business office in Europe, and still contend plausibly that it does not have a European establishment? The general answer must be "no." If there is a fixed place at which business activities are carried on on behalf of an enterprise, this is the very meaning of "establishment" in European law. The office must be licensed as a branch, or incorporated as a subsidiary.

For tax purposes, however, there are some possible exceptions to this generalization. The tax treaties with Belgium, Germany, Italy, and the Netherlands provide that a place of business used exclusively for *purchasing* shall not be considered an establishment. The tax treaty with France has a slightly different provision with similar effect. In Germany there is no permanent establishment for tax purposes by virtue of activities which persist for less than twelve months.

An interesting question suggests itself in relation to the current activities of various American companies in gathering information on possible investments, or obtaining information on the progress of existing investments. Must the company's representatives do their business from hotel rooms, using always a personal address? Or may they rent an office, hire a secretary, and write "New World Mfg. Co." over the door? We cannot find that this question has been the subject of either legislation or litigation in Europe. Our collaborators incline to the opinion that if the American company's representatives neither make nor receive offers to buy or sell—leaving all such matters for direct correspondence between European prospects and the home office in the States—, such an office can be

³⁰ Decree No. 1345 of Dec. 23, 1958, art. 3. Previously, French law recognized the validity of exculpatory clauses.

maintained without fear of involving an "establishment" in commercial or tax law.

6. WITHDRAWING AN ESTABLISHMENT

Today, all eyes are on the opening of establishments. American companies are hurrying to get sites and form business connections with European firms; European officials in many countries are luring foreign investors with cheap real estate, tax concessions, and low-interest loans. These are times for an investor to pinch himself and ask what will be the problems in case the establishment proves unwise and must be withdrawn.

Officers of a well known American factory in one European country told us that they are thinking of moving to another country, but doubt if local officials will "let us." This is a figure of speech, since local officials have no power to force companies to keep operating. But all the ingenuity which they know how to use to induce a company to come in can be very effectively used to deter them from going out. Large amounts of income tax may be found to be due because of understated assets, overstated depreciation, and the realization through sale of previously unrealized appreciation of fixed assets. Friendly assessments of property may suddenly turn hostile; exchange licenses to withdraw the investment may be hard to get. Plant may prove unsaleable because buyers are not assured of permits to make alterations. Conceivably an easier means of withdrawal will eventually be supplied by new uniform laws or treaty provisions covering international mergers. The Member States have promised to "engage in negotiations" looking to this end.³¹ In the meantime, any withdrawal of an establishment is likely to involve a greater sacrifice of going-concern values than would usually be expected in the United States.

C. SUMMARY ON ESTABLISHMENT

If an enterprise wishes to avoid all European problems, the safest course is, of course, to do no business with Europeans. But it need not be quite so cautious; it may sell to Europeans for payment in the United States without serious involvement in European law. The important line of demarcation is that the enterprise must own no property in Europe and be owed no money by Europeans.

Once the American enterprise has merchandise in Europe, or accounts payable by Europeans, it is potentially concerned with Euro-

³¹ The Treaty art. 220.

pean law and procedure; it may have to hire a European lawyer to protect its interests. But this need is contingent on running into legal difficulties. If all debtors pay up, and there are no arguments about property, the American enterprise may coast along for years without a thought of European law or litigation.

In this state of potential involvement, without actually feeling any pain, an American enterprise may own goods in Europe, own accounts payable in Europe, license patents, and maintain personnel temporarily or even permanently in Europe so long as they do not buy or sell but perform only technical services.

If, however, the American enterprise decides that it wants to keep people in Europe to sell for it, or solicit sales, during more than short and casual visits, it must make a choice. Either it must "establish" in the countries involved—by branch or subsidiary—or it must choose a registered European commission merchant to represent it. In the former case, the company's European activities become fully subject to European commercial and tax laws; in the latter, they may remain completely immune. Companies which desire only to purchase in Europe—without selling—are more fortunate; in most countries, they can open an office without incurring European tax burdens on their income or capital, although they are required to conform to European commercial licensing and registration provisions.

II. THE FORM OF ESTABLISHMENT

We turn our attention now from the enterprise which is deciding whether or not to create a European establishment to the enterprise which has decided to establish itself on the continent. This it may do in two main ways—by setting up a European branch, or by incorporating a European subsidiary.

The distinction between a branch and a subsidiary is a legal one. To production managers and sales managers it may seem unimportant. We have heard many executives refer to "our Swiss branch," or "our Italian branch," when further investigation reveals that the Swiss or Italian operation is not in legal terms a branch but a subsidiary.

To lawyers, the distinction is fundamental, and its legal consequences are great. A branch of an American company is an establishment whose property is bought and sold in the name of the American corporation; its supreme authority lies in the American board

of directors, and its fundamental constitution is the articles of incorporation first filed in an American state. A European subsidiary is a company whose fundamental constitution was first filed in a European state; it has a name distinct from that of its American parent, and its property is bought and sold in the European name; its supreme authority in law (if not in practice) is exercised by the shareholders of the European company.

The choice between branch and subsidiary presents itself at more than one level. There is first the question whether the American company should maintain European branches, or form European subsidiaries. There is a further question whether one of the European subsidiaries should have branches in various European countries, or whether there should be a separate subsidiary for each country in which the American company wants to conduct business operations. We will take up these questions one at a time.

A. BRANCH OR SUBSIDIARY

In discussions of European trade, it is common to assume without even discussing the matter that any European establishment should take the form of a subsidiary company. We do not challenge the correctness of this assumption in most cases, but there are certainly some situations in which it is inapplicable. For instance, American banks and transportation companies generally operate through branch offices. One of the reasons is economic, not legal; their customers demand the responsibility of the entire enterprise, not of some fraction of it. A legal reason is that the transactions of transferring money or goods or people cannot be severed in mid-Atlantic so as to have a different corporation at each end. These examples are sufficient to show that experienced international organizations do not always choose the subsidiary form. We think that most lawyers will want to determine for themselves whether their enterprises belong in the large class for which subsidiary organization is indicated, or in the smaller group for which branches are appropriate.

I. U.S. INCOME TAXES

For most American enterprises, subsidiary organization rather than branch has been dictated by U.S. income tax considerations, and may continue to be. However, the tax factors merit re-examination in the light of the characteristics of the particular enterprise, and of possible legislative developments. Legislation which was proposed to the 86th Congress would have gone far to eliminate the

U.S. tax disadvantages of a branch.³² Although most of the proposed changes were deleted before the bill was passed, the facts that such legislation was proposed and that some remnants of it were enacted suggest that a re-evaluation of branch advantages may be appropriate for many companies.

Even if there are no legislative changes, some kinds of enterprises do not get the same tax advantage from subsidiary organization which others do. One principal advantage is the non-taxability of subsidiary earnings which are allowed to remain in the foreign subsidiary. If all the earnings of the foreign subsidiary are to be immediately repatriated, there is no advantage from this source. Consequently, enterprises which do not plan to reinvest abroad their foreign earnings should consider carefully whether the subsidiary arrangement has merits for them.

Subsidiary organization should be regarded even more dubiously by enterprises which do not intend to earn net income abroad. In this category fall companies which use Europe chiefly as a place to buy supplies (like American watch merchants) or to perform services which have been paid for in the United States (like travel and shipping companies).

2. EUROPEAN TAXES

The American enterprise will also want to consider what differences the choice between branch and subsidiary makes to European taxes. It will be particularly interested in provisions of the double taxation treaties which bind the United States to all of the Common Market countries except Luxembourg.³³ For example, they all provide that American enterprises shall not be taxed on profits other than those allocable to the permanent establishment in the taxing country.³⁴ They all provide that there shall be no tax at all on the profits of establishments whose only activities are purchasing.³⁵

³² H.R. 5, 86 Cong. (1959). See Prentice-Hall Federal Tax Report Bull., Mar. 3, 1960.

³³ Cited *supra* note 24.

³⁴ Treaty with Belgium art. III(1); Treaty with France art. III; Treaty with Germany art. III(1); Treaty with Italy art. III(1); Treaty with the Netherlands art. III(1).

The Belgian, German, and Italian treaties have added a clause not found in the French and Dutch, providing that the local establishment shall be allowed taxable income deductions for its allocable share of general administrative overhead, which presumably refers to overhead incurred at the home office or parent company: Treaty with Belgium art. IV(4), as added by Treaty with Belgium, Sept. 9, 1952, T.I.A.S. 2833; Treaty with Germany art. III(4); Treaty with Italy art. III(5).

³⁵ Treaty with Belgium art. III(2); Treaty with France art. III; Treaty with Germany art. III(2); Treaty with Italy art. II(1) c; Treaty with the Netherlands art. II(i), and art. III(2).

They all have an anti-siphoning clause, providing that the taxing country may "rectify the accounts" of the establishment, if it is paying its American affiliate more for goods than would be paid to an unrelated seller.³⁶

The general effect of these provisions is apparently to eliminate any substantial advantage under European taxes which a subsidiary might have over a branch, or vice versa. However, the apparent effect of such legislative provisions is not always the same as the practical effect. We have heard suggestions from some experienced businessmen that in practice it is easier to agree with European tax assessors on the taxes due from a subsidiary than on those from a branch; the assessors are less likely to "rectify the accounts" of the former than of the latter. Other informants are dubious of this difference, and we are unable to evaluate the respective reports. For an analysis of European taxes on American-owned establishments in Europe, we refer the readers to Chapter XI *infra* by Mr. van Hoorn and Professor Wright.

3. POLITICAL AND PUBLIC RELATIONS

Close in importance to taxes are political and public relations. Some of our informants are extremely emphatic about the advantage of operating a "local" company in each country. In France, executives of a large American-owned French subsidiary explained how they must go to government officials for permission to expand the plant, or to make a wage adjustment, or to obtain foreign exchange for materials purchases, or for making a public offering of securities. Even borrowing money from a bank is in France a form of dealing with the government, since most of the banks are state-owned; and the *Crédit National*, which rediscounts intermediate term loans, is a bank specially formed by the government to promote national economic interests.

All these agencies base their decisions on the national interests of France. Each decision depends on whether, in the officials' opinions, the company's activities will benefit the French economy; whether the long term gain outweighs the immediate inflationary effect of increasing construction, increasing wages, spending foreign exchange and expanding credit. Inevitably, the building up of a "French" company appeals more readily to these officials than the building up of an "American" corporation, even though the former is known to be American-owned.

³⁶ Treaty with Belgium art. IV(2); Treaty with France art. IV; Treaty with Germany art. IV; Treaty with Italy art. IV; Treaty with Netherlands art. IV.

Localization also helps to recruit the best types of executive personnel. To be the general manager of a French company gives a sense of prestige and security which cannot be given to the manager of a French branch which is a very small fraction of the American company's entire operation.

These differences between subsidiary organization and branch organization are more marked in some countries than others. Our French and Italian informants have been very emphatic about them; our Belgian and Luxembourg informants give them little weight. We suspect that this disparity of opinion reflects real differences in conditions in the various countries. So far as the differences relate to dealings with government officials, they will obviously vary with the extent of government intervention. France and Italy are countries in which government controls are extremely pervasive; Belgium and Luxembourg are countries with a high degree of economic freedom. France and Italy have had a wall of protective tariffs and exchange controls; Belgium is traditionally free-trading, with a minimum of exchange regulation.

Although comments on national psychology are to be treated with great reserve, we think there are genuine differences in the prevailing attitudes in different European countries toward foreign enterprise. The inhabitants of Benelux recognize without embarrassment the smallness of their economic sphere; association with foreign enterprise gives a sense of security, rather than insecurity. Frenchmen are much slower to accept the idea that a foreign enterprise may offer them something which a domestic enterprise could not.

We therefore accept the view that there are reasons of a psychological character, quite aside from any legal rules, which make a subsidiary preferable to a branch, at least in France and Italy. In the Benelux countries, the psychological factor is of doubtful significance, and the reasons for subsidiary organization (which prevails there as elsewhere) have been chiefly U.S. tax reasons. Our German reports, although less explicit, are more like those from the Benelux countries.

4. COMMERCIAL FILING AND REGISTRATION

All the European countries require filing of the organic documents of a company in the Commercial Register, the Court of Commerce, or some combination of these.³⁷ Four out of six countries also re-

³⁷ Filing of documents:

Belgium: C. COM. I-IX, art. 10, as amended by Law of July 9, 1935.

France: Decree No. 58-1355 of Dec. 27, 1958, [1959] JOURNAL OFFICIEL DE LA RÉ-

quire newspaper publication.³⁸ In order to be filed the documents must first be translated into the local language. The documents to be filed vary somewhat from country to country. Universally they include the articles of incorporation and any subsequent amendments. In Belgium, Italy, and Luxembourg they also include annual financial statements, statements of profit or loss, and changes in directors and officers, so that re-filing and re-publication must be made at least annually.³⁹ In France and the Netherlands the larger of the companies which are listed on stock exchanges, and some of their subsidiaries, must publish financial statements.^{39a}

These requirements apply in rather parallel fashion to branches of foreign companies, and to domestic companies.⁴⁰ However, the same filing requirement may be quite different when it is applied to different forms of organization. If the parent company has a long

PUBLIQUE FRANÇAISE 990 (requiring registration by domestic and foreign companies); Decree No. 54-37 of Jan. 6, 1954, [1954] JOURNAL OFFICIEL DE LA RÉPUBLIQUE FRANÇAISE 565 (registration to cover name, business, address, and personal information on manager or managers).

Germany: GESETZ ÜBER AKTIENGESSELLSCHAFTEN UND KOMMANDIT-GESSELLSCHAFTEN AUF AKTIEN (AKTIENGESETZ) (hereinafter cited as AktG) §§ 28-29 (registration of company), § 35 (registration of branch of stock company); GESETZ BETREFFEND DIE GESELLSCHAFTEN MIT BESCHRÄNKTER HAFTUNG (hereinafter cited as GmbHG) §§ 7-8 (registration of limited liability company), § 12 (branch of limited liability company); HANDELSGESETZBUCH (hereinafter cited as HGB) § 13 (general provisions).

Italy: CODICE CIVILE art. 2506 (requiring deposit in commercial register of articles of incorporation, financial statements, and names and signatures of managers). In practice, filings are made with clerk of Court of Commerce, since Commercial Register has never been set up.

Luxembourg: COMPANY LAW art. 160 (foreign companies to file and publish as if domestic).

Netherlands: HANDELSREGISTER-WET art. 8 (name and address of company, and personal details on officers).

³⁸ Publication:

Belgium: C. COM. I-IX, art. 80 (names, professions, and addresses of members of governing boards and auditors).

France: Law of 1867, arts. 56-57, as amended by Decree-law of Oct. 30, 1935 (extract of articles to be published).

Germany: HGB § 10 (commercial register entries to be published in official gazette and a newspaper).

Luxembourg: COMPANY LAW arts. 8, 9, 11, 48 (requiring publication in official journal of articles and of financial statements of stock companies).

³⁹ Repetition:

Belgium: C. COM. I-IX, art. 80.

Italy: CODICE CIVILE art. 2506.

Luxembourg: COMPANY LAW § 48.

^{39a} France: Ordinance No. 59-247, Feb. 4, 1959; Journal Officiel, Feb. 8, 1959, p. 1754; L'Actualité Juridique 1959. III. 62.

Netherlands: W.K. art. 42 c.

⁴⁰ Italy is an exception. Amendments of charter need not be filed, nor changes in officers other than managers of the Italian branches.

charter, the burden of translating and filing it may be considerably greater than that of forming a subsidiary and filing its charter; the burden is perhaps more likely to be felt with respect to filing amendments in the country of each establishment. When the Chase National Bank merged with the Bank of Manhattan, new articles of incorporation had to be filed in Paris because of the Paris branch. If the Paris establishment had been a subsidiary (which is not practicable in the case of a bank), no such filing would have been necessary.

Similar considerations may apply to publication of financial statements where, as in Belgium, they are required. Branches and subsidiaries are subject to the same requirement, but the branch must publish the statements of the whole company to which it belongs while the subsidiary needs to publish only its separate statement.

5. THE FOREIGN MERCHANT'S IDENTITY CARD

In addition to registering the establishment, the laws of Belgium and France require a permit for the general manager or president, if he is a foreigner. This executive must have a "foreign merchant's identity card" (*carte d'identité de commerçant étranger*). In France the card is issued after the prefect has been satisfied that the proposed commercial activity is useful to the economy and that the applicant has a good business record. The prefect satisfies himself on the former point by consulting the trade associations of the industry in which the applicant intends to be active. This might seem to give the local merchants a veto on new competition; presumably it does, as far as concerns businessmen like brokers, who pursue their occupations as individuals. As to corporations, the competitors have the power only to force the company to have a local president, by rejecting the foreign one; the foreigner who is rejected as president may serve instead as technical director. Therefore the foreign merchant's card is not likely to be denied on economic grounds. The "good business record" of the applicant is commonly determined by statements from chambers of commerce.

The practical difficulty presented by the foreign merchant's card is only a matter of delay. Several months may elapse between application and issue, but eventual denial has not been, we are told, a frequent problem for Americans.

In Belgium, the foreign merchant's card is harder to come by; in practice, foreign concerns find it best to appoint Belgians as chief executives of their Belgian branches and subsidiaries.

In both countries, the "foreign merchant's card" is the same problem for a branch as it is for a subsidiary.

6. LIABILITY FOR OBLIGATIONS OF BRANCHES AND SUBSIDIARIES

In any vast commercial network, the responsibilities of one sector of the network for the obligations of other sectors present a complex problem. We would like to divide the problem into two main parts. The first part of the problem arises when the sector in which the obligations were incurred becomes insolvent, and cannot pay its debts; the question arises whether the other sectors can be made to pay. We will call this the *insolvency* problem.

The second problem is quite different. We assume that the sector in which the obligations were incurred is quite able to pay them, but for some reason the plaintiff elects to bring his suit in some other sector. A classic American illustration of this problem is the case in which an individual was injured by a street car in the Philippine Islands, and elected to sue the parent company, which owned the street car operating company, at the parent company's home in Connecticut;⁴¹ one can imagine similar suits arising from subsidiaries in Europe. Suits of this sort have acquired in the United States the name of "migratory suits," and we will therefore refer in this connection to the *migratory suit* problem.

We do not think the insolvency problem will loom large in the plans of American enterprise; they will plan to pay the debts which their subsidiaries incur. But it is a hazard which merits some attention even though it is marginal.

a. *The Insolvency Problem: Branch Organization*

If a European branch of an American corporation proves unable to pay its debts, there is no doubt of the European creditors' right to sue the corporation in the United States, or wherever else it might be found. It is a single legal person, regardless of the number of its branches. If the suit had been first brought to judgment in Europe, any court in the United States would recognize its validity, since the establishment of a European branch would give the European court "jurisdiction" by American standards. If the cause of action had never been sued on in Europe, an original suit on it could be begun in the United States.

⁴¹ *Costan v. Manila Electric Co.*, 24 F. (2d) 383 (2d Cir. 1928).

b. *The Insolvency Problem: Subsidiary Organization*

If an American corporation forms subsidiaries in Europe, rather than branches, a very different problem is presented. In Europe, as in America, different corporations are different persons. The fact that one owns stock in another is not enough to make both liable for the same debt.

But sometimes stock ownership is not the whole story of the corporate relationship. There may be 100% ownership, or near it; there may be intermingled management and intermingled property; there may be such inadequate capitalization that insolvency should have been foreseen; there may even have been an intention to incur obligations which would never be discharged. Which, if any, of these circumstances will lead to a judgment that the American parent is liable for the European subsidiary's debts?

A preliminary question, in considering this problem, is what law would govern. Since the European subsidiary is by hypothesis insolvent, the liability of the parent would most likely be litigated in an American federal court. If so, a federal court would decide which legal regime to apply. But the events which would determine the legal regime would almost inevitably be distributed between two continents, and a plausible ground could be found for applying the law either of the European country most involved, or of the United States.

Readers are already familiar with American judicial reactions to the question of when a parent corporation should be made to pay the debts of an insolvent subsidiary. They know that American courts—especially federal courts—have held shareholders and affiliated corporations liable for debts contracted by a company which is formed largely to acquire assets for its owners, but which has no substantial independent existence, whether measured in terms of capital investment or of management structure.⁴² The court disregards “the entity,” or “the fiction”; it “pierces” or “draws aside” the corporate veil.

Germany has experienced a very similar development of legal theory, in which *Durchgriff der juristischen Person*e, [piercing the artificial person] and *Missachtung der Rechtsform* [disregard of

⁴² For authoritative summaries of American law, see BALLANTINE, CORPORATIONS 298-303, 311-321 (1946); LATTIN, CORPORATIONS 66-72 (1959); STEVENS, HANDBOOK ON THE LAW OF PRIVATE CORPORATIONS, 85-95 (1949). For a case suggestive of the type of problem which a foreign subsidiary might present, see *Weisser v. Mursam Shoe Corporation*, 127 F.2d 344 (2d Cir. 1942), involving a leasehold corporation.

legal form] take the place of the American magic words.⁴³ Some of the factors which have been determinative in American cases are also influential in German cases; the mingling of personal and company assets is most prominent, but inadequate capitalization is also recognized.⁴⁴ We cannot say whether German courts are generally more or less disposed to "pierce the veil"; the comparatists' observation that American case-law is far more developed on this subject⁴⁵ suggests that our courts may be more disposed to "pierce."

In France, we encounter no theory of "piercing" or "disregard," but the same effects are achieved, and with a vengeance. The doctrinal basis is called "abuse of entity" [*abus de la personnalité*], the idea being that the establishment of a corporation may be a mere pretense, designed to exploit unfairly (that is, to "abuse") the privilege of limited liability. When the courts detect the abuse, they search for the real principal (the *commerçant de fait*), and hold him liable. This principle, which grew out of case law, is now a clause in the French bankruptcy act, which provides,

When a company is declared bankrupt, the bankruptcy may be declared to include any other person who, disguising his acts as those of the company, has carried on business for his personal benefit, and has dealt with the corporate assets as though they were his own.⁴⁶

Professor Houin offers the following comment on the application of this rule:

If the subsidiary is a mere department of the parent company, if the majority of its shares are held by the parent company or its shareholders, if the governing board members are the same, if the accounting is more or less intermingled, if personnel pass freely from one company to the other,—then the court will say that the two companies are really only one entity and one fund; their debts are the same, and so the bankruptcy of either brings in its train the bankruptcy of the other.

⁴³ SERICK, RECHTSFORM UND REALITÄT JURISTISCHER PERSONEN, (Beiträge zum Ausländischen und Internationalen Privatrecht, No. 26, 1955); SERICK, DURCHGRIFFS-PROBLEME BEI VERTRAGSSTÖRUNGEN (Juristische Studiengesellschaft Karlsruhe, No. 42, 1959); DROBNIG, HAFTUNGSDURCHGRIFF BEI KAPITALGESELLSCHAFTEN, (Arbeiten zur Rechtsvergleichung, No. 4, 1959).

⁴⁴ DROBNIG, *op. cit.*, *supra* note 43, at 28, 47.

⁴⁵ *Id.* at 25; *cf.* SERICK, RECHTSFORM UND REALITÄT JURISTISCHER PERSONEN 65, 66.

⁴⁶ Decree No. 55-583 of May 20, 1955, art. 10, [1955] JOURNAL OFFICIEL DE LA RÉPUBLIQUE FRANÇAISE 5086. Identical provisions were formerly part of C. COM. art. 437, as amended by a decree-law of 1935.

Thus it appears that French and German courts are not unlikely to impose liability on parent companies (to the extent that parent companies are within their power) when subservient subsidiaries become bankrupt. A subsidiary will not be a good "insulator" against debts in those countries, unless it can be shown to be truly independent (within the varying standards of independence).

In the other countries of Europe, the imposition of liability on these grounds is not yet a known peril. Our Belgian, Luxembourg, and Netherlands collaborators report that the "abuse of entity" and "disregard of entity" doctrines have not yet been used in their countries, although analogous effects may be attained in relation to enemy property.

However, parent corporations may easily incur liability in Italy or in France because of failure to have the necessary number of shareholders. The Italian code declares that a sole owner is liable for debts contracted during his sole ownership.^{46a} In France, one hundred percent ownership of a subsidiary's stock would probably make the parent liable for all the subsidiary's obligations on the theory that the subsidiary cannot be a "company" if it has only one member.

c. The Migratory Suit Problem: Branch Organization

The migratory suit problem, unlike the insolvency problem, is one which may disturb an American company even though it is determined to pay all the just debts incurred in its operations. In fact, the sounder the company, the more likely a victim it is for the migratory suitor. This is the danger that a plaintiff with a cause of action which arose in Honolulu will choose to sue in Frankfurt or Paris.

The company's objection to such suits is not that it does not want to pay Honolulu plaintiffs, but that it does not like to litigate with them at a distance of several thousand miles from all the witnesses and the documents.

This hazard may be viewed in two forms. One is the danger that the European branches will be the victims of suits arising in the United States (or in other continents where branches may be found); the other danger is that European branches will give rise to suits which may be prosecuted in the United States (or other continents).

^{46a} C. Civ. 2362 (stock companies). Experts disagree on the effectiveness of dummy "shareholders" in fulfilling the legal requirement.

Taking first the problem of suits brought in Europe, it appears to us that there is no legal defense against such suits. If the defendant resides within the court's area, the court has jurisdiction, regardless of the place of origin of the cause of action; and establishment of a branch is regarded as equivalent to residence. European courts do not seem to apply the doctrine of *forum non conveniens*.

On the other hand, we have not encountered any American company which has experienced serious inconvenience from this source. Three peculiarities of European practice offer possible explanations. One is that the contingent lawyer's fee is unknown in Europe; probably most of the migratory suits in the United States are filed by lawyers on contingent fees. A second reason is that in European procedure, the parties are not allowed to testify. Therefore a Honolulu plaintiff cannot transport his law-suit to Paris merely by transporting himself; he must bring witnesses, too; and this makes the suit just as inconvenient for him as it is for the defendant. Third, the plaintiff must pay the defendant's counsel fees if he fails to win his case, and the foreign plaintiff must deposit security in advance to assure this payment.

We take up next the problem of suits originating in Europe but prosecuted in the United States. For instance, a European might be injured by a defective machine manufactured by an American corporation's German branch, and might sue in New York. Conceivably the court might refuse jurisdiction on the ground of *forum non conveniens*; otherwise the suit would lie. If the injured plaintiff were one of the hundreds of thousands of Americans who tour Europe each summer, the plea would probably be rejected. Thus branch organization increases a company's exposure to migratory suits.

In practice, this problem has not been an acute one for American companies; but we do not find any explanation except that the branch form of organization has been very little used. We are inclined to think that migratory suits are a real danger for companies whose activities may occasion personal injuries. It is a valid reason for avoiding branch organization.

d. *The Migratory Suit Problem: Subsidiary Organization*

If an American company operates in Europe only through subsidiaries, it appears to be relatively safe from migratory suits in Europe. The European subsidiaries are different legal persons from the parent, and there seems to be no danger that any of the Euro-

pean doctrines would support the suit. These doctrines have sometimes visited the sins of the subsidiaries upon the parents, but never vice versa.

A suit against the parent in the United States presents no great dangers, either. If we look to the relevant European doctrines, we find that they have never held the parent liable except when the subsidiary has proved insolvent or has only one shareholder; the migratory suit problem has not appeared. Thus the only danger lies in the application of United States doctrines on disregard of corporate entity. Without fully exploring this engaging topic, we may say that if the parent rigorously separates the operations of the subsidiary from its own, and the subsidiary avoids insolvency, danger should be avoided.

7. CHANGE OF FORM: INCORPORATING A BRANCH

In the United States, the choice between a branch and a subsidiary form is far from irrevocable. If a branch is opened, but subsidiary organization later appears preferable, the branch may be incorporated without serious tax consequences; the exchange of stock for proprietorship is not regarded as a realization of taxable income. Further, the taxes incurred by transferring the assets (for example the documentary stamp tax on the deed of real estate) are negligible.

In Europe, the opposite is true. The transfer of assets to a new corporation in exchange for stock is regarded as a realization of income. If the stock is worth more than the incorporators' basis for the assets, augmented by any retained earnings on which income taxes have been paid, income is realized. European accounting commonly employs "hidden reserves" which understate annual income. This practice, although perhaps improper, is so generally followed that tax writers take for granted the appearance on liquidation of previously unreported earnings. As a result of the practice, a very large amount of income tax which had been postponed becomes payable when a branch is incorporated, as well as when a subsidiary is dissolved.

There are also taxes in some European countries on the transfer of all kinds of assets to a company in exchange for stock. The Belgian rate, for instance, is 1.6%. The combined effect of these taxes and the income taxes is to discourage formation of a branch with the intention of later incorporating it as a separate subsidiary.

The deterrents to forming a subsidiary with the intention of turn-

ing it later into a branch are even greater. The dissolution of a subsidiary generally results in a "sale" of the fixed assets, incurring taxes reported as 8% in Italy, 11% in Belgium, and 15% in France of the value of the assets. Rates on transfer of the inventory are lower—about 4 or 5%. There are sometimes means of effecting a tax-free merger, but such avenues of escape are the exception rather than the rule in Europe.

8. CLOSING OUT THE OPERATION

We have spoken so far of the relative advantages of a branch or of a subsidiary in *carrying on* operations. But the investor must also give some attention to their relative advantages in *closing out* operations; that is, disposing of it to outsiders. If the operation proves unprofitable, it will have to be closed out. Even if it proves successful, the operation in a neighboring country may be so much *more* successful that the investor will want to liquidate his German establishment (for instance) in order to concentrate his operations in France. The formation of the Community has already produced some such results, while the projected changes in tariffs and quotas are still in their infancy.

One way to close out is to sell the assets for cash. This results in the same taxes already discussed in relation to a change of form from branch to subsidiary, or vice versa. There is a tax on previously unrealized or unreported income, and transfer taxes on the assets. The burden is the same for a branch as for a subsidiary.

Another way is to sell the shares owned in the European enterprise. This involves no tax at all, or taxes in very small amounts; for instance, in Germany, less than one-fourth of one percent of the par value of the shares.

Obviously the sale of shares is much more advantageous, at least to the seller. But this option is available only if the European operation has been cast in a subsidiary form; one cannot sell shares in a branch. This is one of many reasons why a subsidiary is so widely preferred for European operations.

A third way to dispose of a European operation, which would suggest itself to an American tax or corporation lawyer, is to merge it with some outside company that wants to buy it. That is, the American subsidiary could be merged with some other European corporation which wished to acquire the assets. Our information on this point is incomplete, but it appears that a merger normally has

no tax advantages over a sale of assets. Heavy taxes on income and on transfer of property are usually incurred.

There are limited exceptions to this rule. A merger between two Luxembourg companies which maintain adequate accounting records is entirely tax-free.⁴⁷ In Belgium, there is a temporary exception, available to Belgian companies which merge during the "first stage" of the European Economic Community—that is, before the end of 1961. It is limited to mergers which "contribute to economic rationalization, higher productivity, or greater employment."⁴⁸ France permits some taxes to be escaped in restricted types of mergers. There have been press reports of similar legislation in Italy. It is possible that further tax concessions to merger will result from the negotiations which the Member States have agreed to undertake with regard to international merger.⁴⁹

Where merger has these advantages, they are advantages only for those investors who have put their investment in subsidiary form: there is no way to merge a branch.

9. SUMMARY ON BRANCHES OR SUBSIDIARIES

For a few enterprises—chiefly banks—the choice of a branch rather than a subsidiary is clearly dictated by the economic needs of the business. For most enterprises, either form is equally functional, and the choice will be dictated by other factors. Among these, U.S. income taxation is likely to prove dominant, and to favor subsidiary organization; but it will have less significance for some types of enterprise—notably purchasing organizations. European taxes on current income are neutral for most enterprises, while the establishment continues; but if the American investor finds it necessary to dispose of his European venture, a subsidiary is likely to offer a much more economical means of getting out. Political relationships will dictate subsidiary organization for many enterprises, especially those which encounter pervasive state regulation. Public filing and registration rules seem fairly neutral, but favor the subsidiary in some cases. If there is a desire to avoid becoming involved in the debts which may be incurred by the foreign operation, subsidiary operation is clearly indicated; but it may fail in its purpose unless the subsidiary is truly independent in its financing and man-

⁴⁷ *Loi sur l'impôt sur les collectivités* (Körperschaftssteuergesetz) art. 15.

⁴⁸ Law of July 15, 1959, as reported by Belgian Industrial Information Service, August 1959, p. 1.

⁴⁹ The Treaty art. 41.

agement. Where the migratory law suit is a problem, subsidiary organization is clearly preferable.

In conclusion, subsidiary organization offers substantial advantages in a majority of situations, but not in all. The factors which have been listed above may prove helpful in making the choice for a particular venture.

B. HOW MANY SUBSIDIARIES?

We leave behind us now the problems of those enterprises which will operate in Europe by means of branch offices of the American company; we turn to the problems of those who have decided to conduct their operations in Europe through one or more subsidiaries. The next question is, how many subsidiaries? There are six sovereign nations in the Common Market; does an American enterprise need a separate subsidiary for each country in which it has decided to create an establishment? Or may it, for example, form a subsidiary in Belgium which can operate as a single European company in Luxembourg, Netherlands, France, Germany, and Italy? In the following pages we will discuss the possibility of such a Belgian company, as an illustration of the problems which would be met by a single European company established in any one of the Common Market countries, and operating through branches in the others.

The question which we ask is somewhat like the one we have already asked about a U.S. company with branches in Europe. Foreign branches of a Belgian company present many of the same problems presented by foreign branches of a U.S. company. But the problems are not quite the same, and we think the question of branches versus subsidiaries should be re-examined with the hypothesis of a European home office. This we will do, with our Belgian illustration.

I. ADVANTAGES OF A SINGLE EUROPEAN COMPANY

The *potential* advantages of having a single European company are obviously great. Geography alone demands that an enterprise be able to fill its orders indiscriminately from warehouses in Amsterdam or Aachen, Milan or Marseilles. The enterprise needs to be able to use the same executives and technicians in Liège as in Verdun.

These advantages will appeal particularly to American businessmen, who are accustomed to plan their operations on a continental scale. Indeed, experience in this sort of operation is one of the prin-

cial advantages which Americans may hope to bring to the European market, where they are in most other respects less experienced than local businessmen. Attaining these advantages is one of the very reasons for which the Common Market has been formed; if they cannot be realized, the Market may be an illusion and a disappointment to many of the American enterprises which plan to enter it.

To be sure, it is possible to operate a single enterprise through a half dozen corporations which are separate only in form. But empty forms are expensive at best, and they lead to more serious problems, to which we will refer later.

2. THE PROSPECTIVE EVOLUTION OF THE COMMUNITY

A further impetus toward the single European company may be found in the planned evolution of the European Economic Community under the Treaty of Rome. All of its provisions are designed to make of Western Europe an area without barriers, and in which, therefore, a single company can operate. Article 52 declares that

restrictions on the freedom of establishment of nationals of a Member State in the territory of another Member State shall be progressively abolished in the course of the transitional period. Such progressive abolition shall also extend to restrictions on the setting up of agencies, branches or subsidiaries by the nationals of any Member State established in the territory of any Member State.

Many intra-Market impediments are to be substantially abolished within the transitory period which should terminate in 1970 (with possible extensions). In addition to restrictions on freedom of establishment, these include tariffs (Article 13), quotas (Article 30), and obstacles to movement of workers (Article 48), and the supply of services (Article 59). In addition the members have promised to coordinate their exchange controls (Article 70) and to "approximate" any other laws which directly affect the workings of the market (Article 100).

Moreover, the reduction of these obstacles is expected to begin well before 1970. In the first few years rapid progress is likely to be impeded by the requirements of unanimous agreement (establishment, Article 54; diplomas and certificates, Article 57; services, Article 63; capital movements, Article 67). But directives by majority action of the council may be issued even in the first stage (1958-1961) with regard to movement of workers; and in the sec-

ond stage (1962-1965) with regard to establishment, diplomas or certificates, services and laws which distort competition. Restrictions on capital movements are subjected to majority rule in the third stage (1966-1969).

3. OBSTACLES TO A SINGLE EUROPEAN COMPANY

While the attractions of a single European company are great, and will become greater as the Economic Community evolves, the practical lawyer cannot overlook the obstacles which exist today, some of which may continue to exist for a long time. We have already had occasion to examine the principal obstacles to use of European branches of an American company in Europe; we must look to see whether the same obstacles oppose themselves to the use of branches of a Belgian company (for instance) in other European countries.

We may start with taxation. This was found to be a principal obstacle to the operation of branch operation by an *American* corporation, and may prove to impede operation of branches by European companies too. Without analyzing the tax structures of the various Community countries, which are the subject of a separate study by Messrs. van Hoorn and Wright, we can say that some discrepancies and overlaps are to be expected, and that they are not necessarily eliminated by the "double taxation" treaties existing among several of the Common Market countries, nor by the provisions of the Treaty of Rome. Specific mention of taxation is found only in Articles 95-99 and 220. Articles 95-99 contain strong provisions, but they apply only to "turnover" and similar taxes on goods. Article 220 is much broader; it refers to "elimination of double taxation," with presumed reference to income taxes. But it does not even give directive powers to the Community Council. It merely pledges Member States to "engage in negotiations."

A third possible avenue of attack on tax obstacles to Community-wide operation may be found in Articles 100 and 101. Article 100 empowers the Council to issue directives with respect to "such legislative and administrative provisions as have a *direct* incidence on the establishment or functioning of the Common Market." Article 101 gives a directive power over provisions which "distort the conditions of competition in the Common Market, and thereby cause a state of affairs which must be eliminated."

Tax deterrents to Community-wide corporate organization would seem to be "indirect" rather than "direct" impediments to the

Market; if they impede progress in all countries equally, they can hardly be said to "distort" competition, although they may retard it a good deal. Thus we would not hold high hopes for the elimination of tax barriers which may presently enforce a policy of separate subsidiaries in separate countries.

A second reason mentioned for setting up subsidiaries rather than branches of the American corporation was to obtain a sympathetic approach from government officials who may pass on the application of an enterprise for a license to build a new plant, to adjust wage rates, to exchange foreign currency, to obtain an import quota allocation, to make a public securities offering. These matters will continue for the foreseeable future to be administered by national, not by international officials. The Community will affect this problem only insofar as the Community reduces the need for dealing with government agencies (by increasing economic freedom), and insofar as the Community diminishes the nationalism of national officials. It may indeed have such effects, but they will be indirect, and may be long delayed.

A final reason for preferring a European subsidiary, rather than a European branch, of an American company was the desire to be insulated from migratory suits, and from debts in case of insolvency of the European enterprise. Both of these objectives are satisfied as well by having one European subsidiary as by having six. As to migratory suits, migration within Europe—for instance from Rome to Brussels—has never been a problem. As to insolvency, the features of inadequate capitalization and domination of subsidiary affairs, which inspire the "piercing of the veil," are more likely to appear in a number of small national subsidiaries than in a larger market-wide subsidiary.

In summary, there are no strong legal obstacles to establishing a single European subsidiary with branches in the other countries. By 1970, this course may be clearly indicated. But in the meantime there are likely to be many inconveniences—difficulties with taxes and with all sorts of administrative regulations—which a single European subsidiary will feel more sharply than separate national subsidiaries would.

4. HARMONIZING SUBSIDIARY OPERATIONS

One special problem of operating through multiple subsidiaries is the necessity of harmonizing their policies to achieve the practical benefits of unified operation. American lawyers are, of course, fa-

miliar with means of operating subsidiaries as if they were mere departments of the parent company. In American practice, the parent company holds all the stock of all the subsidiaries, and the parent's board frequently makes all major decisions for subsidiary companies; the boards of the various subsidiaries carry out these decisions. But several complications will be encountered in applying this pattern in the Common Market.

On the purely technical plane, there is the rule against the sole ownership of any company's stock by a single individual or company. This can be solved without much difficulty by issuing single shares to chosen persons who will make up the necessary complement of two, five, or seven shareholders.

A more serious problem is involved in getting the most out of the local directors. The parent company needs keen and devoted local directors in each subsidiary, to solve distinctive local problems. Normally it will install such directors, and award them salaries from the subsidiary's treasury, plus bonuses based on the subsidiary's profits. They may be expected to devote themselves to the building up of their company.

Unfortunately, the devotion of this group of local directors is likely to collide with the objectives of the European operation seen as a whole. It may become advantageous to transfer operations from the French subsidiary (for instance) to the Italian subsidiary. The change may cut the bonuses and imperil the salaries of the French directors. Under these conditions, or the threat of these conditions, it may be difficult to attract and hold French directors; or they may lose the initiative and the sense of responsibility which would have resulted from a truly independent French operation.

An ingenious solution to this problem has been suggested. The American parent needs a European policy board, to which the top executives of all the subsidiaries will belong. Part of their bonuses might be based on profits of the subsidiaries as a group, rather than solely on those of their own national subsidiaries. At the least, they should meet together, and acquire a Common Market perspective, and they should be made to feel that their futures depend not only on the success of their national segment of the enterprise, but on the success of the whole. This feeling can be given reality by moving executives from one subsidiary to another. Language differences will impose some limits on this shifting, but it will not be hard to find French-speaking Italians who can work in France, Belgium, or Lux-

embourg and German-speaking Dutchmen or Luxembourgers who can work in Germany.

A European policy board will do more than develop European thinking for the parent company. Western Europe now has a twelve year plan for the evolution of its commercial institutions and its economic life. If advantage is to be taken of the burgeoning opportunities which present themselves, there must be continuous thinking about European operations by people who are close to them; decisions cannot be left for peripheral attention by an American board.

Various legal structures for the European board may be imagined. There might simply be meetings among the directors of the various European subsidiaries; this arrangement would probably fail to supply the needed authority and cohesion. An outstanding solution which has come to our attention is the one announced in the summer of 1958 by the Ford Motor Company, which opened a European office of its International Division. Such a branch would not need to buy or sell, and could therefore escape all the legal effects of "establishment"; at the same time, it could furnish a center of harmonization, and a pole of loyalty.

Whatever structure is adopted, one peril of harmonization must be noticed. It may involve violation of European laws on "restraint of trade." Article 85 of the Treaty of Rome prohibits agreements which result in "(a) the direct or indirect fixing of purchase or selling prices or of any other trading conditions; (b) the limitation or control of production, markets, technical development or investment; [or] (c) market-sharing or the sharing of sources of supply." These provisions purport to be self-operating but will have to be enforced by Member States until implemented by action of the Council.

What should be expected from these provisions is not yet known; another chapter of this book, by Professor Riesenfeld, discusses the problem. Obviously there is some possibility that the harmonization of subsidiaries' policies may run afoul of the Common Market's "antitrust" laws. If this should occur, an enterprise might be better off operating as a single company with branches; a single company cannot make an illegal "agreement" with itself.

A single European company might also violate the competition rules of the Treaty. Under Article 86, a single enterprise with a dominant position in the Common Market is forbidden to limit "production, markets or technical developments to the prejudice of

consumers." But this article does not outlaw a single company's market-wide price policy, or marketing plan, as Article 85 outlaws them for a combination of different companies.

5. A EUROPEAN HOLDING COMPANY

Many writers in the past year or two have advocated the formation by an American enterprise of a European holding company to possess the enterprise's shares in foreign operating companies in European countries.

One function of such a holding company is to serve as coordinating agency for the policies of the various operating subsidiaries. But this can be done by establishing a European policy board without the added complication of a holding company.

A second function of some European holding companies has been to conceal the identity or nationality of the investor. This factor has been of great importance in a continent which has been twice in the last half-century tormented by wars, and parts of which have suffered political or racial purges. But concealment is quite impossible for most of the investors whose problems are considered in this paper—that is, American manufacturers who want to exploit in Europe their well known products, processes, or trademarks.

This leaves as the principal function of a European holding company the supplying of a financial conduit, through which the profits of one European subsidiary can be passed to another without passing through any U.S. company. For if the profits pass through an American company, they emerge minus taxes. Such a conduit will be of special interest in the Common Market, because of the possibility that operations now conducted in several of the Market countries may later be concentrated in one of them.

However, a holding company is not the only conceivable means of passing funds from one company to another. Where all the operating subsidiaries are wholly owned, the funds can perhaps just as well be loaned from one to the other. The need of a holding company for European subsidiaries is likely to arise chiefly when the European nationals hold a substantial minority, or a majority, of the company in which the American enterprise has invested. In such cases, the European shareholders will not share the Americans' enthusiasm for transferring the company's resources to an affiliated company in another country.

Three European countries have been widely mentioned as sites for European holding companies—Switzerland, Liechtenstein, and

Luxembourg.⁵⁰ We are advised that arrangements can be made with the Netherlands government to exempt from tax income received from subsidiaries in other countries, although there is no express statutory exemption.⁵¹

Although all these four countries may serve equally well as tax havens, they are not likely to serve equally well as profit conduits, because of differences in their positions with regard to exchange restrictions. If European currencies become soft again, there will be a tendency for countries to protect themselves by restricting withdrawals, or restricting the terms on which new investments may be made. Within the Common Market, the countries have committed themselves to maintaining a high degree of liberality, and their restrictive measures can be reviewed and overruled by the Community Council.⁵² The commitments on exchange control between Switzerland and the Common Market countries are much less effective. Hence a holding company located in Luxembourg or Netherlands has a probability of being able to invest and disinvest in other Common Market countries with a good deal more assurance than a holding company in Switzerland or Liechtenstein.

6. MERGING SUBSIDIARIES

The momentary advantages in having several subsidiaries within the Market, and the prospective later advantages of having a single Common Market subsidiary suggest to an American that subsidiaries should be formed now and merged later with other European companies. There are many obstacles to this course, and it should not be planned.

Merger between companies of different countries is presently impracticable. One cannot merge a French company with a German one as he can merge a Delaware corporation with a Pennsylvania one. There are some prospects for future legislation which will permit international mergers; this is one of the subjects on which the Community members promise to "engage in negotiations."⁵³ But one cannot be certain of it.

⁵⁰ Luxembourg: Law of July 31, 1929, "sur le régime fiscal des sociétés de participations financières"; see DELVAUX AND REIFFERS, *LES SOCIÉTÉS "HOLDING" AU GRAND-DUCHÉ DE LUXEMBOURG* (1953).

⁵¹ See Chapter XI *infra*.

⁵² Treaty, arts. 67-73. By its first directive under this article, the Council has ordered all member states to grant a general license for purchases of securities traded on the stock exchanges of member states, and to grant all licenses that may be required to permit direct investment, and offerings of new securities, among member states. See Directive No. 1 under Article 67, May 11, 1960.

⁵³ The Treaty, art. 220.

There are also some temporary exemptions from the income taxes which would normally be incurred on merger, in order to permit companies to adjust themselves to the Common Market. But these exemptions are not sure to persist to the time when merger may be desired, and when international agreements may have made it possible.

7. SUGGESTED CONCLUSIONS

We have offered a host of considerations for examination in the light of the circumstances of each individual enterprise. What conclusions should be drawn? We will offer a few.

In the Benelux group of three countries, a single company operating across national lines is already practical. For some years General Motors has been operating a Belgian company (General Motors Continental) with a branch factory in Netherlands; their officers report complete satisfaction with the arrangement. They feel that Dutch officials give their branch just as favorable treatment as could have been expected for a purely Dutch company. Most companies appear to be still operating with separate subsidiaries in these nations (Ford Motor has separate subsidiaries for its Dutch and Belgian plants), but we discovered no opinion that this offers any great advantage today.

Outside of Benelux, we know of no instance of international branch operation of factories, although there are many branch banks, transportation offices, and purchasing agencies. We are prepared to accept the conclusion reached by most enterprises that the time has not yet come when it is most convenient to operate an Italian or German factory as a branch of a Belgian company.

On the other hand, we think that the time will come, and very probably within the transitional period of the Common Market. It may be accelerated not only by the abolition of restrictions and by the harmonization of laws, but also by "antitrust" laws which impede the harmonization of policies of separate companies.

The one thing certain is that the best form of organization today may not be the best form tomorrow. This means that in deciding to establish in any country the cost estimates should include the expenses of a probable reorganization within a few years. If the combined costs are too high, the decision should be to defer establishment in the countries where it can most practicably be dispensed with. The market in those countries may be exploited through the use of commission agents, or merely by exports from a foreign base.

We will hazard one more opinion. As the Common Market evolves, conditions will become progressively more favorable to operations of a single European company, and less favorable to operations of a number of European subsidiaries. If the choice between one subsidiary and many is a close decision under today's condition, the single subsidiary should be favored; the future is more likely to increase than to decrease its advantage.

III. FORMING A EUROPEAN SUBSIDIARY

A. THE EUROPEAN COMPANY LAWS

I. FAMILY RESEMBLANCES (AND DIVERGENCIES)

When we make the decision to form a European company, we find ourselves face to face with the European company laws. For the six countries of the Community, there are six systems of company law—all different. And there are not six, but *eight* sets of legal texts, since two of the countries present their laws in two official languages (Belgium in French and Flemish; Luxembourg in French and German).

That is taking the worst possible view of the matter. On the brighter side, we may notice that four languages cover all eight of the legal texts (French, German, Italian, and Dutch). Furthermore, a knowledge of the French language will permit the reader to examine official texts of three countries (France, Belgium, and Luxembourg), and to examine the translated texts, with latest amendments, of the other three nations.⁵⁴ Texts of the relevant laws of all six countries will probably soon be available in German, also.⁵⁵

Moreover, all of the six company law systems reveal strong mutual resemblances, as seen from an American perspective. One discovers again and again concepts which are common to the six countries but unfamiliar in any of the fifty American states. All of the legal systems share basic concepts which were enunciated in the

⁵⁴ A Paris publisher, Editions Jupiter, prints a loose-leaf service containing the company laws of the six countries, together with analysis and practical suggestions, under the title *RECUEILS PRATIQUES DU DROIT DES AFFAIRES DANS LES PAYS DU MARCHÉ COMMUN*. (Hereinafter *Rec. Prat. du M.C.*) In this collection everything not originally in French is translated into that language; Italian and German legal texts in their original languages are also included.

⁵⁵ The publishers of the *Rec. Prat. du M.C.* have advised us that they will shortly issue a German language edition. German language translations of company laws of foreign countries are also published by the *Gesellschaft für Rechtsvergleichung* at Frankfurt, Germany.

Napoleonic Civil and Commercial Codes.⁵⁶ The company laws of Luxembourg, Belgium and Italy also reflect a strong influence of the French Company Law of 1867, which is still in effect in France although considerably amended. German company law contains more radical differences from the French pattern, reflecting in part its independent historical development. While all the European company laws will strike an American lawyer as rather rigid, perhaps even old-fashioned, he will come closest in the Netherlands to discovering the liberty of organization and finance to which he may have been accustomed within the hospital boundaries of Delaware.

Some day, perhaps, there will be uniform company laws throughout the Common Market. A committee in France, and perhaps others elsewhere, are studying the possibility. But the Common Market members are not committed, even in theory, to uniformity in this area. So the six regimes of company law are likely to be with us for some years to come.

2. WHERE TO FIND THE LAWS

Few of the European company laws can conveniently be studied in English.^{56a} Most of the English translations which have been made are hopelessly out of date; only the Netherlands⁵⁷ law and Italian⁵⁸ laws have recent translations which have come to our attention. For neither is there any service in English to keep it up to date.

When we turn to the original sources, we find a confusing variety of arrangements. The famed "codification" of European law, whereby all laws are integrated in a single, compact, consecutively numbered collection, applies to business company laws in only three of the six countries—Belgium, Italy, and the Netherlands. In Belgium and the Netherlands the principal company laws are cited as a part of the Code of Commerce.⁵⁹ In Italy, surprisingly, they are

⁵⁶ For a short discussion of the evolution of Dutch commercial and company law, see Correa, *La Pratique des Sociétés aux Pays-Bas*, 1 Rec. Prat. du M.C., Pays-Bas, Part 1.

^{56a} For a bibliography of sources which can be studied in English, see Szladits, *International and Foreign Law Sources for the Business Lawyer*, 15 BUS. LAW. 575 (1960).

⁵⁷ Internationaal Juridisch Instituut, Netherlands legal provisions of companies limited by shares (Netherlands 1957); VAN DER MEER, *DUTCH CORPORATION LAW* (1959).

⁵⁸ An English translation of Italian company law was published in 1957 by Medio-banca, under the title *THE AMERICAN INVESTORS' DIGEST OF ITALIAN CORPORATE LAW*.

⁵⁹ Belgium: CODE DE COMMERCE, Liv. I, Tit. IX; WETBOEK VAN KOOPHANDEL, Boek I, Tit. IX.

Netherlands: WETBOEK VAN KOOPHANDEL, art. 15-56h. There are, of course, general principles applicable to companies in many parts of the Civil Codes, especially in the parts on contracts of associations. There are also special corporation acts, like the Netherlands Act on cooperative associations, which are not integrated. The state-

cited as a part of the Civil Code,⁶⁰ because of the achievement in 1942 of a long-sought-after unification of civil and commercial law. Even more surprisingly, they are found in the division of the civil law dedicated to labor law;⁶¹ this oddity reflects the "corporative state" concepts of fascism which were in vogue in the Italy of 1942, but it has no significant bearing on the content of the company law nor on the system of citing it.

In the other three countries the principal laws applying to companies have become quite separate from the commercial codes, as economic change has forced radical revisions of company laws while other portions of the commercial code retained more ancient dress. Of all the countries France has the most uncoded collection of company laws, reflecting the vicissitudes of national history almost as picturesquely as the architectural face of Paris.⁶² Some of the principles which underlie company law are still to be found in the Civil Code (Articles 1832-1873), although they yield, in commercial matters, to other general rules found in the Code of Commerce (Articles 18-46). For specific questions of French company law one must usually turn to particular laws which we will call the "Stock Company Law" and the "Limited Liability Company Law." But the French have no such handy names for them; they call them (respectively) the Law of July 24, 1867, and the Law of March 7, 1925.

The Stock Company Law has been greatly amended, so that not much more than its skeleton remains to witness the will of the 1867 legislator. The later legislators have sometimes despaired of hanging any more on the old skeleton, so we have further laws which certainly modify the effects of the law of 1867, but which are not framed as amendments to it, and must be separately cited. Notable examples are the laws of November 16, 1940, and March 4, 1943—both products of the "collaborationist" government at Vichy. Although neither the Stock Company Law nor the Limited Liability Company Law are formally parts of the Commercial Code, they are always contained as annotations in popular editions of the Code, along with the Vichy overlays and other supplementary legislation.

ment in the text applies to a set of rules on business corporations which is approximately as comprehensive as, for instance, the American "Model Business Corporation Act."

⁶⁰ CODICE CIVILE arts. 2247-2510.

⁶¹ Libro V "Del Lavoro."

⁶² See Houin, *Reform of the French Civil Code and the Code of Commerce*, 4 AMERICAN JOURNAL OF COMPARATIVE LAW 485 (1955). Professor Houin advises that a new codification of French company law is in an advanced stage of preparation, and might even be promulgated in 1960.

The legal situation in Germany and Luxembourg is somewhat less confusing. Both have relatively modern and comprehensive company laws which are entirely separate from the Civil and Commercial Codes. Germany has a Stock Company Law, dating from 1937, and a separate Limited Liability Company Law dating from 1892. Luxembourg has a single Companies Law, separate from its codes, containing provisions on stock companies, limited liability companies, and other types of business association. The German company laws are contained in popular editions of the German Code of Commerce (*Handelsgesetzbuch* or *H.G.B.*), but the Luxembourg laws are available only in a separate booklet.⁶³

The principal company laws to which we will refer repeatedly are shown on page 47 with the usual term of citation in the country of origin, and the abbreviated citations which we will use here.

B. THE CHOICE OF COMPANY FORM

1. THE KINDS TO CHOOSE FROM—AND THEIR NAMES

In five of the six Community countries—all but the Netherlands—the American lawyer who has decided to form a “corporation” will confront an initial puzzle. Each of these countries has not one, but two forms of business organization which may fairly be called corporations. Both are widely used, both are legal entities, both are taxed in essentially the same way, and both insulate their shareholders from liability for company debts.

These two forms bear witness to the European legislators’ desire to provide separate legal structures for the entities which Americans call “publicly held corporations,” and those which we call “close corporations.” One type of European company is empowered to offer its shares to the public, and list them on stock exchanges and is obliged to endure the glare of publicity on its financial affairs. The other type of European company is confined to offering its shares to a select few, has shares unsuitable for trading, and enjoys relative privacy. In these respects the European dichotomy appears much like the American.

But the American dichotomy is a differentiation of fact—a difference in how the shares are actually held and traded. Legally both kinds of companies (close corporations and publicly held corporations) belong to the same category (“business corporation,” or

⁶³ Recueil des lois concernant les Sociétés Commerciales (1956).

<i>Country</i>	<i>Law</i>	<i>Cited in country of origin as:</i>	<i>Cited here</i>
Belgium	Code of Commerce Book I, Title IX	Code de Commerce, Liv. I, Tit. IX; Wetboek van Koophandel, Boek I, Tit. IX.	C. Com. I-IX
France	Stock Company Law	Loi du 24 juillet 1867, sur les sociétés	Law of 1867
	Limited Liability Company Law	Loi du 7 mars 1925, tendant à instituer des sociétés à responsabilité limitée	Law of 1925
Germany	Stock Company Law	Gesetz über Aktiengesellschaften ("Aktiengesetz")	AktG
	Limited Liability Company Law	Gesetz betreffend die Gesellschaften mit beschränkter Haftung (GmbH Gesetz)	GmbHG
Italy	Civil Code, art. 2247-2574	Codice Civile, art. 2247-2574	C. Civ.
Luxembourg	Company Law	Loi du 10 août 1915 concernant les sociétés commerciales; Gesetz vom 10 August 1915, betreffend die Handelsgesellschaften ⁶⁴	Company Law
Netherlands	Code of Commerce art. 15-56h	Wetboek van Koophandel, art. 15-56h	W.K.

"corporations for profit"), they add the same distinguishing words or letters to their corporate name (Co., Corp., Inc. and the like), and they are formed under provisions of the same statute (for example, the Delaware General Corporation Law, or the Illinois Business Corporation Act). To pass from the "close" form to the "publicly held" form requires, at most, minor charter amendments, and the filing of securities registration statements.⁶⁵

⁶⁴ The provisions governing limited liability companies, although not adopted until 1933, are framed as an amendment of the law of 1915. Hence, we cite the "Law of 1915" for provisions which were not in effect until many years after that date.

⁶⁵ The distinctions between the American close corporation and the European limited liability company have been brought out in a series of articles advocating that American states should adopt separate close corporation laws; see the following (in historical order): Weiner, *Legislative Recognition of the Close Corporation*, 27 MICH. L. REV. 273 (1928-29); Rutledge, *Significant Trends in Modern Incorporation Statutes*, 22 WASH.

In Europe, on the other hand, these two kinds of company signify different legal categories, add different words or initials to their corporate names and are formed under different statutes.⁶⁶ To pass from one legal form to the other requires the adoption of a completely new charter, through a procedure called "transformation."

American and English writers have used many different translations for these kinds of companies, frequently varying according to which European country is involved.⁶⁷ For simplicity we will use the

U.L.Q. 305, 338-339 (1937); Fuller, *The Incorporated Individual: A Study of the One-Man Company*, 51 HARV. L. REV. 1373, 1406 (1938); Winer, *Proposing A New York "Close Corporation Law"*, 28 CORNELL L.Q. 313 (1943); O'Neal, *A Plea For Separate Statutory Treatment of the Close Corporation*, 33 N.Y.U.L. REV. 700 (1958).

⁶⁶ An English language introduction to the limited liability company in various European countries may be found in the following articles: Eder, *Limited Liability Firms Abroad*, 13 U. of PITTS. L. REV. 193 (1952); Israels and Taubenblatt, *The Close Corporation in Foreign Law*, (1948) STATE OF NEW YORK, REPORT OF THE LAW REVISION COMMISSION 416; Schneider, *The American Close Corporation and its German Equivalent*, 14 BUS. LAW. 228 (1958); Treillard, *The Close Corporation in French and Continental Law*, 18 LAW & CONTEMP. PROB. 546 (1953).

⁶⁷ I have chosen the term "stock company" for the *Aktiengesellschaft* or *société anonyme*, and the term "limited liability company" for the *Gesellschaft mit beschränkter Haftung*, or *société à responsabilité limitée*. The affirmative reasons for these choices are the following: (1) Neither term has a strong positive connotation in American law, such as to imply a greater parallelism than the laws justify. (2) Both terms are literal translations of the European terms in use in some or most of the countries surveyed. "Stock company" translates the German and Italian terms; "limited liability company" translates the French, German, Italian, Luxembourg, and Dutch terms, and barely misses the Belgian. (3) The two terms, both using the word "company," emphasize that they designate species of a single genus.

More compelling, however, than these affirmative reasons, are my objections to alternative terminologies which have been occasionally used or suggested: (1) "Anonymous company" or "nameless company" as a translation for "*société anonyme*" is the nadir of namesmanship. It connotes nothing. (2) "Corporation" as a translation for "*Aktiengesellschaft*" or "*société anonyme*" leads into a trap. If the SA-AG is also called corporation, we have got nowhere. If the SARL-GmbH is called some kind of "company," while the SA-AG remains a "corporation," the difference in terminology implies a greater difference in kind than really exists. The use of the term "corporation" leads into endless other difficulties. On the American side, the term properly includes such entities as municipal corporations, which are never signified by the corresponding European terms of *société* and *Gesellschaft*. On the European side, the "corporation" has cognates (*corporation*, *corporazione*, *Körperschaft*, *corporatie*) with quite different denotations. (3) "Close corporation" as a translation of *GmbH* or *SARL* is bad because the question whether a corporation is "close" or not is a matter of fact; whether it is a *GmbH* or an *AG* is a matter of law. An *AG* or *SA* can be closely held in fact, so that it corresponds functionally to an American "close corporation." (4) "Public company" and "private company" are perfectly usable terms with which to describe the European SA-AG and SARL-GmbH, respectively. They have disadvantages in suggesting an exaggerated parallelism between British and continental institutions. Further, the word "public" strongly suggests "governmental" to the American reader.

The following incomplete bibliography on others' usages may be of some interest: "Limited Liability Company" (for SARL-GmbH): FRIEDMANN et al., *LEGAL ASPECTS OF FOREIGN INVESTMENT* (1959).

"Stock company" (for SA-AG): Eder, *Spain: New Law of Stock Companies*, 1 AM. J. COMP. LAW 117 (1952); Eder, *Spain: Law of Stock Companies*, 2 AM. J. COMP. LAW 234 (1953).

same two translations, regardless of country. Our terminology is compared with the national originals as follows:

	"Stock Company"	"Limited Liability Company"
Belgium:	société anonyme (SA)	société de personnes à responsabilité limitée (SPRL)
	naamloze vennootschap (NV)	personenvennootschap met beperkte aansprakelijkheid
France:	société anonyme (SA)	société à responsabilité limitée (SARL)
Germany:	Aktiengesellschaft (AG)	Gesellschaft mit beschränkter Haftung (GmbH)
Italy:	società per azioni (SpA)	società a responsabilità limitata (SARL)
Luxembourg:	société anonyme (SA)	société à responsabilité limitée (SARL)
	anonyme Gesellschaft (AG)	Gesellschaft mit beschränkter Haftung (GmbH)

The Netherlands is like the United States, and unlike the rest of Europe, in having only one statute under which both closely held and publicly held companies are formed. Companies of both types are legally called "naamloze vennootschap," just as both are legally called "corporation" in the United States. The initials "N.V." appear before or after the company name. If the company happens to be closely held, it may be described by bankers as "besloten," which means "closed." But the appellation of "besloten naamloze vennootschap" (like "close corporation") denotes a factual distinction, rather than a legal one. There is no widely used Dutch term for a "publicly held corporation."

Of course there are many other kinds of business associations, beside the stock company and limited liability company. In every country there are partnerships and limited partnerships, just as in the

"Limited Liability Firm" (for SARL-GmbH): Eder, *op. cit. supra* note 66; Eder, *Colombia: Control of Limited Liability Firms*, 2 AM. J. COMP. LAW 70 (1953); Eder, *Venezuela: Commercial Code*, 5 AM. J. COMP. LAW 628 (1956).

"Close corporation" (for SARL-GmbH): Reverdin and Homburger, *The American Close Corporation and Its Swiss Equivalent*, 14 BUS. LAW. 263 (1958); Israels and Taubenblatt, *op. cit. supra* note 66 at 416.

"Corporation" (for SA-AG): FRIEDMANN *et al.*, *op. cit. supra*; but cf. FRIEDMANN *et al.*, *THE PUBLIC CORPORATION* (1954).

"Public companies and private companies" (for SA-AG and SARL-GmbH, respectively): Treillard, *op. cit. supra* note 66, at 546.

United States.⁶⁸ There is also in most of the European countries a "limited partnership with shares,"⁶⁹ and there are a number of special purpose companies such as mutual insurance companies, co-operative associations, and credit unions.

None of these business associations seem likely to be of much interest to American traders and investors. Cooperatives and credit unions are inherently local. The limited partnership with shares is a survival of the slow evolution from partnership to stock company, comparable in its role to the American "joint stock company." Today it seems to offer no advantages which are not exceeded by those of the more usual stock company or limited liability company. The general partnership seems to be excludable as an avenue of American investment, since the participants become fully exposed to all the financial risks of a European businessman.

⁶⁸ Partnerships:

Belgium: société en nom collectif (vennootschap onder gemeenschappelijke naam), CODE DE COMMERCE (hereinafter cited as C. COM.) Livre I, Titre IX, §§ 15-17.

Germany: Offene Handelsgesellschaft, Handelsgesetzbuch (hereinafter cited as HGB) §§ 105-160.

France: Société en nom collectif, CODE DE COMMERCE (hereinafter cited as C. COM.) §§ 20-22.

Italy: Società in nome collettivo, CODICE CIVILE §§ 2291-2312.

Luxembourg: Société en nom collectif—offene Handelsgesellschaft, loi du 10 août 1915 concernant les sociétés commerciales (hereinafter cited as Company Law) §§ 14-15.

Netherlands: Vennootschap onder eene firma, WETBOEK VAN KOOPHANDEL (hereinafter cited as W.K.) §§ 16-18.

Limited Partnerships:

Belgium: Société en commandite simple—vennootschap bij wijze van enkele geldschieting, C. COM. I-IX, arts. 18-25.

Germany: Kommanditgesellschaft, HGB §§ 161-177.

France: Société en commandite simple, C. COM. §§ 23-28.

Italy: Società in accomandita semplice, CODICE CIVILE §§ 2313-2324.

Luxembourg: Société en commandite simple—einfache Kommanditgesellschaft, Company Law §§ 16-22.

Netherlands: Vennootschap bij wijze van geldschieting, *or* vennootschap en commandite, W.K. §§ 19-35.

⁶⁹ The organizations referred to resemble limited partnerships in that some members are liable for firm debts, while others are not, but they differ from limited partnerships in their power to issue transferable shares. They have had a historical role as precursors of the modern stock company and limited liability company, somewhat like the role of the "joint stock company" in American law; but it would be quite misleading to call them "joint stock companies."

The following table indicates their various national names, and the laws applicable:

Belgium: Société en commandite par actions—Vennootschap bij wijze van geldschieting op aandelen, C. COM. I-IX, §§ 105-115.

France: Société en commandite par actions, Law of 1867, §§ 1-20.

Germany: Kommanditgesellschaft auf Aktien, Aktiengesetz (hereinafter cited as AktG) §§ 219-232.

Italy: Società in accomandita per azioni, CODICE CIVILE §§ 2462-2471.

Luxembourg: Société en commandite par actions—Kommanditgesellschaft auf Aktien, Company Law §§ 102-112.

Netherlands: Commanditaire vennootschap op aandelen.

The limited partnership may deserve some consideration from a few American investors. Conceivably an American company could be a limited partner, while an individual (American or European) might be the general partner in Europe. European limited partnerships are very much like American limited partnerships under the Uniform Partnership Act, for the simple reason that the Anglo-American limited partnership is a business form which was directly and consciously copied from a European model.⁷⁰ However, the number of American enterprises which would wish to participate in a European limited partnership would be very small, and we will not, in this paper, give further attention to this form.

The "holding company" has also received a good deal of attention in recent years from European writers and American observers. It is not, however, a distinctive form of organization; it is rather, as in the United States, the adaptation of one of the other forms of company (usually stock company or limited liability company) to a particular purpose.⁷¹

2. THE LIMITED LIABILITY COMPANY—ITS PROS AND CONS

Most American corporations seem to have cast their European subsidiaries, except in Germany, in the mold of stock companies.⁷² On the other hand, European businessmen choose the limited liability much more often than the stock company; the ratio of preference in France was recently about $3\frac{1}{2}$ to 1 and was apparently even higher in Germany.⁷³ Although many of the reasons why Eu-

⁷⁰ See Crane, *Are Limited Partnerships Necessary?* 17 MINN. L. REV. 351 (1933).

⁷¹ The only European country of the Six which has a special holding-company statute is Luxembourg:

Loi du 31 juillet 1929 sur le régime fiscal des sociétés de participations financières (holding companies), reprinted in *Recueil des lois concernant les sociétés commerciales* (1956); Gesetz vom 31 Juli 1929 über die Besteuerung der Holdinggesellschaften, reprinted in "Gesetze betreffend die Handels, Holding-, und andere Gesellschaften" (1956).

However, the holding company is widely used in the Netherlands and other countries of the Common Market, without benefit of special legislative provisions.

⁷² A casual survey of well-known American subsidiaries in Europe has revealed no limited liability companies except in Germany. General Motors and Standard of New Jersey both have German sub-subsidiaries which are limited liability companies: Frigidaire GmbH, which is a subsidiary of Adam Opel AG (sub of General Motors); and Vereinigte Asphalt-und Teerproduktion Fabriken GmbH, which is a subsidiary of Esso AG (sub of Jersey Standard). Moody's Industrial Manual (1959) 1648, 2734. But Mr. Dieter Schneider, a lawyer of Cologne, states that "foreign subsidiaries in Germany are generally established in the form of a GmbH." *The American Close Corporation and its German Equivalent*, 14 BUS. LAW. 228, 249 (1958).

⁷³ 1 Rec. Prat. du M.C., sub. tit. *Indications pratiques* for France states that in 1957, 3270 SARL were formed, compared with 952 SA. The ratio of total companies in existence favors the SARL even more strongly.

Europeans might prefer the limited liability company do not apply to Americans, we believe that this form deserves more consideration than it has commonly received. We suspect that its unpopularity among Americans results partly from the fact that it looks strange and unfamiliar. We will, therefore, try to outline some of its distinctive features in various countries, starting with its disadvantages, and proceeding to some bases for preferring it.

a. *Non-Negotiability of Shares*

One feature of limited liability companies which will probably deter some investors is the non-negotiability of their shares. Stock companies in all the countries but Italy normally issue bearer certificates, which are transferred from one investor to another without any entry on the corporate books;⁷⁴ the bona fide purchaser prevails over all prior claimants. In Italy stock companies no longer issue bearer shares, but registered shares are considered "negotiable" just as in the United States.⁷⁵ Limited liability companies shares are never considered negotiable; they must always be transferred on the books of the company; in Germany the transfers must even be notarized;⁷⁶ in Italy no certificates of ownership are issued. The buyer of a limited liability company share (with or without a certificate) takes it subject to any adverse claims of title, any claim of the company for unpaid share subscriptions, and any restriction on transfer, to which the transferor was subject.

In some, but not all, countries, there are further impediments to

In Western Germany, figures of companies in existence in 1955 showed 34,254 GmbH against 3,060 AG. Rec. Prat. du M.C., *Indications pratiques* for Germany.

⁷⁴ Belgium: C. Com. I-IX, art. 45.

France: C. Com. art. 35.

Germany: AktG § 10.

Luxembourg: Company Law art. 37.

Netherlands: W.K. art. 38c.

⁷⁵ Company Law (C. Civ. 2355) permits bearer shares as in other countries, but royal decrees have suspended the permission since 1941 (decrees of Oct. 25, 1941, and Mar. 29, 1942). Hence, all share transfers must be registered and are governed by C. Civ. arts. 2021-2027. But there is no provision, as in the limited liability company law, that transfers are ineffective even between the parties until registered.

⁷⁶ Belgium: C. Com. I-IX, art. 125 (share transfer not effective until registered).

France: Law of 1925, arts. 21 (shares not negotiable), 23 (transfer incomplete until the company is formally notified).

Germany: Gesetz betreffend die Gesellschaften mit beschränkter Haftung (hereinafter cited as GmbHG) § 15. (requiring that all transfers be made with judicial or notarial formality).

Italy: CODICE CIVILE art. 2479 (transfer ineffective until registered).

Luxembourg: Company Law art. 190 (transfer incomplete until the company is formally notified).

free trading in shares. In Belgium, France, and Luxembourg shares in a limited liability company cannot be sold to non-members without the consent of a specified majority of the other shareholders.⁷⁷ This provision puts a minority shareholder at the mercy of the controlling group. It has been found so burdensome that Frenchmen often form a stock company in preference to a limited liability, even though they intend the company to be closely held.

This rule requiring consent to transfer does not apply in Germany and Italy, unless it is voluntarily inserted in the corporate charter.⁷⁸

b. *Exclusion from Financial Markets*

A second disadvantage of the limited liability company is the fact that it cannot raise money by public issue of stocks and bonds, nor can its securities be traded on the securities markets. Some of the countries have a specific prohibition against public issue or trading.⁷⁹ In others the same effect is achieved by prohibitions against issuing the kinds of securities which outside investors would want to buy. One of these prohibitions is the one on issuing negotiable shares, explained in a preceding paragraph. A further prohibition, effective in Belgium, France, Italy, and Luxembourg, prohibits the issue of bonds—that is, debt securities in forms designed for sale to small investors.⁸⁰

These prohibitions do not prevent limited liability companies from financing themselves from private sources. The rules about stock would be no impediment to shareholding by a select group of individuals nor, except in Belgium, by a parent or a consortium of investing companies; only the general public are excluded. Likewise loans can be “privately placed” with banks and insurance companies. Since public issues of bonds are relatively less important in Europe than in the United States, the inhibition on public bond issues will probably not make much practical difference to a company until it becomes very large and well-known.

⁷⁷ Belgium: C. Com. I-IX, art. 126.

France: Law of 1925, art. 22.

Luxembourg: Company Law art. 189.

⁷⁸ Germany: GmbHG § 15(5).

Italy: C. Civ. art. 2479.

⁷⁹ Luxembourg: Company Law. art. 188.

France: Law of 1925, art. 37.

⁸⁰ Belgium: C. Com. I-IX, art. 131.

France: Rec. Prat. du M.C., France, Exposé juridique no. 14.33.

Italy: CODICE CIVILE art. 2486.

Luxembourg: Company Law art. 188.

c. Other Disadvantages

A few other special features of the limited liability company which may deter its use at particular times and places must be mentioned. Belgium has a peculiar rule requiring that all shareholders be natural persons and not corporations.⁸¹ Our Belgian collaborator regards this as a rule of substance, not form. Hence the limited liability company must be written off as a form of corporate subsidiary in Belgium; but it might make a good affiliate for an American close corporation, whose principal shareholders could also hold shares in the Belgian limited liability company.

France has a rule of income taxation whereby the salaries paid to majority shareholders of a limited liability company are regarded as profit distributions, rather than as wages, and incur a 22% basic tax (before the progressive surtax) instead of the 5% payroll tax which falls on salaries of stock company officers. This has driven many French businessmen to desert the limited liability company in favor of a stock company; but it will not be any problem to American-owned limited liability companies, since it is unlikely that their salaried officers will be majority shareholders. We presume that shares will be held by corporations rather than individuals.

Italy has a set of unfavorable tax rulings which have been applied to the limited liability company. On the one hand, its profits are subjected to the corporation income tax, which partnerships and individual enterprises escape; on the other hand, its share transfers are subjected to a business transfer tax which corporation shares escape. Thus it has double disadvantages. Until one of these inconsistent rulings is abandoned, the limited liability company must be avoided in Italy; but our collaborators view this problem as temporary. When it is solved, the Italian limited liability company may be a relatively attractive form of enterprise.

Most of our collaborators report that the limited liability company is viewed with suspicion by creditors, because it has been so often used for under-capitalized enterprises which eventually failed; the stock company on the other hand enjoys a presumption of financial responsibility. We suppose, however, that the presumption against the limited liability company is readily rebutted by evidence of adequate capitalization, or by the parent company's willingness to guarantee particular undertakings.

⁸¹ Belgium: C. COM. I-IX, art. 119.

d. *Restrictability of Share Transfers*

We referred above to restrictions on transfer as possible disadvantages in the limited liability company. Restrictions *are* a disadvantage to a capitalist who wants to induce maximum financial participation in his company by outside investors.

But we have found that many American corporations, contemplating investments in foreign countries, are much more concerned with keeping investors out than with getting them in. Such corporations issue a very minimum of shares to others than the parent corporation itself, and require each recipient to agree in writing to make no disposition without consent.

Where the desire is to minimize public participation in the company's equity, the limited liability company offers definite attractions. In Belgium, France, and Luxembourg the shares are automatically non-transferable unless a specified majority of the other shareholders consents.⁸² In Italy and Germany the law does not impose this restriction, but permits its insertion in the company charter.⁸³

It is true that some degree of non-negotiability is also attainable in stock company shares. Professor Houin believes that the numerical majority of French stock companies would be found to have rules restricting stock transfer. But restrictions on transfer are not expressly authorized by the stock company laws of most countries,⁸⁴ and the extent to which transfers may be validly restricted is not clearly defined either by case law or by legal theory.⁸⁵

⁸² Belgium: C. Com. I-IX, art. 126.

France: Law of 1925 art. 22.

Luxembourg: Company Law art. 189.

⁸³ Germany: GmbHG § 15 (expressly stating that transfers may be restricted by charter provisions).

Italy: C. Civ. art. 2479 (stating that shares are transferable in the absence of contrary provisions in the articles of incorporation) (*salvo contraria disposizione dell'atto costitutivo*).

⁸⁴ Germany expressly authorizes charter restrictions on transfer: AktG § 61(3). But many desired forms of restriction are beyond the statutory authorization: See SCHLEGEL-BERGER-QUASSOWSKI, KOMMENTAR ZUM AKTIENGESETZ § 71, Anmerkung 9 (1939).

⁸⁵ An interesting exchange of views of the subject in Belgium is contained in a pair of comments by Coppens, 64 JOURNAL DES TRIBUNAUX 215 (Belgium 1949), and de Rouvreur, 55 REVUE PRATIQUE DES SOCIÉTÉS CIVILES ET COMMERCIALES 54 (Belgium 1956); cf. VAN RYN, PRINCIPES DE DROIT COMMERCIAL, Part I, at 364 (1954); for Germany see Schneider, *op. cit. supra* note 66, at 233.

e. Number of Shareholders

A second feature of the limited liability company which may attract some Americans is the smaller number of shareholders required. In Belgium, France, and Luxembourg a stock company requires seven shareholders,⁸⁶ while a limited liability company requires only two.⁸⁷ According to the prevailing view of lawyers in these countries, the shareholders must be bona fide in that they must pay their own money for their shares. But they need not hold more than one share a piece; and they may be bound by contract to assign the share to someone else on demand of the parent company.⁸⁸

European lawyers generally do not consider shareholder requirements as a weighty consideration. Even if they are violated, the principal consequence (in Belgium, France, and Luxembourg) is liability to an annulment proceeding, which in France can be arrested by restoring the number of shareholders to seven (provided they have never dropped below two).⁸⁹ Since a shareholder's derivative suit cannot be brought by less than five percent of the shareholders, European lawyers have no such fear of small shareholders as American lawyers generally do.

Whatever the merits of this European view may be, we believe that most American parent companies in fact will be extremely cautious in the selection of the other six shareholders, and in maintaining amicable relations with them. The time and trouble involved in finding six such shareholders and keeping them happy can be cut down by using the limited liability company form, which requires only one shareholder in addition to the parent company.

The difference in required number of shareholders has less significance in the other countries. In Italy two shareholders are enough for either type of company.⁹⁰ Even if there is only one, the company does not cease to exist; it merely ceases to insulate the sole shareholder from personal liability for debts of the company.⁹¹ In Germany there is a difference in the number of incorporators required

⁸⁶ Belgium: C. Com. I-IX, art. 29.

France: C. Com. art. 23.

Luxembourg: Company Law art. 26.

⁸⁷ Belgium: C. Com. I-IX, art. 119.

France: Law of 1925, art. 5.

Luxembourg: Company Law art. 183.

⁸⁸ Cf. Lepaulle and Jeantet in FRIEDMANN, *LEGAL ASPECTS OF FOREIGN INVESTMENT* (1959) at 214, 220-221.

⁸⁹ *Ibid.*

⁹⁰ Italy: C. Civ. art. 2247.

⁹¹ *Id.* art. 2362.

(five against two),⁹² but there is no objection to 100% ownership by a single shareholder after the company is once formed.⁹³ Hence the selection of the extra incorporators does not demand much attention in either Germany or Italy. The Netherlands has no limited liability companies, but two incorporators are enough to form a stock company, and the number of shareholders after incorporation does not need to be more than one.

f. Number of Officers and Directors

A third attractive feature of the limited liability company is the simplicity of management structure permitted by law. A small limited liability company can operate with no board of directors, no president, no auditors and only a single manager.⁹⁴ It is not even necessary to hold a shareholders' meeting to elect the manager; he may be named in the articles, and hold office indefinitely without the necessity for annual elections.⁹⁵

This simple arrangement is not recommended as a permanent structure in any company; but it may be extremely convenient in the early years of a foreign venture. The parent company may not know to whom it can wisely entrust the decision-making power in a European country; it will hope to avoid naming board members whom it may later wish to remove and replace.

In contrast, the stock company is required by law to provide itself with a panoply of officialdom which is sometimes quite premature. The requirements are most elaborate in Germany, where every

⁹² AktG § 2: Five members; GmbHG § 2: Specifying no number, but implying plurality.

⁹³ BAUMBACH-HUECK, AKTIENGESETZ § 30 (9 ed. 1956).

⁹⁴ Belgium: C. COM. I-IX, art. 129. But a board of auditors must be named, if there are more than five shareholders. *Id.*, art. 134. The single manager is called a *gérant*, or *beheerder*.

France: Law of 1925, art. 24. But if there are more than 20 shareholders, a board of supervision (conseil de surveillance) must be named, *id.* art. 32. The single manager is called *gérant*.

Germany: GmbHG § 6. But there must be a supervisory board (Aufsichtsrat) if there are over 500 employees, by the terms of the Betriebsverfassungsgesetz of Nov. 10, 1952, § 77. The single manager is called a *Geschäftsführer*.

Italy: C. Civ. art. 2487. But an auditing committee (*collegio sindacale*) is required if the capital is over 1,000,000 lire (about \$1500). *Id.*, art. 2488. The single manager is called an *amministratore unico*.

Luxembourg: Company Law art. 191. There is no limit on the size of the company which may be governed by a single manager, called *gérant* or *Geschäftsführer*.

⁹⁵ Belgium: C. COM. I-IX, art. 129.

France: Law of 1925, art. 24.

Germany: GmbHG § 6.

Italy: C. Civ. arts. 2487 and 2383.

Luxembourg: Company Law art. 191.

stock company must have a supervisory board (*Aufsichtsrat*) of three or more members, none of whom are either executives or employees of the company, and who must hire one or more executives (*Direktoren*).⁹⁶ In other words, the investor in a stock company must find three policy-makers whom he trusts enough to put them in charge of his business, but who are not employed in it, plus one full-time executive. In a limited liability company he needs to find only the executive.

A similar number of persons must be found in Italy—at least three auditors (*sindaci*) who are neither employees of the company nor relatives of the manager, and at least one manager (*amministratore*).⁹⁷ But the choice is a little less momentous, since the three auditors do not have the extensive powers of the German supervisory board.

In France and Belgium, four persons must also be found to fill the necessary positions—three managers (*administrateurs*) and at least one auditor (*commissaire*).⁹⁸ The directors may be employees of the company, but the auditors must be strictly independent—not employed by the directors or by the company, and not related by blood or marriage to the directors.⁹⁹ The requirements are the same in Luxembourg, except that there are no express prohibitions of other relations between the auditor and the company or its directors.¹⁰⁰

The privilege of operating a limited liability company with a single manager is available only to “smaller” enterprises, but the criteria of smallness vary greatly. In Italy, the line is drawn at the meager capital of 1 million lire (about \$1,500); above that, auditors are required.¹⁰¹ In Germany, the line is drawn at 500 employees; with more, a 3-man supervisory board is required.¹⁰² In Belgium and France, the line is drawn in terms of number of shareholders; such a line need never be crossed by a typical corporate subsidiary. The penalty for crossing is a three-man board of auditors.¹⁰³ Only Lux-

⁹⁶ AktG §§ 70, 86, 90.

⁹⁷ C. Civ. arts. 2380, 2397, 2399.

⁹⁸ France: Law of Nov. 16, 1940, art. 1 (*administrateur*); Law of 1867, art. 32 (*commissaires*).

Belgium: C. Com. I-IX, arts. 55 and 64.

⁹⁹ France: Law of 1867, art. 33.

Belgium: C. Com. I-IX, art. 64 quater (as amended by law of Dec. 1, 1953).

¹⁰⁰ Luxembourg: Company Law art. 61.

¹⁰¹ Italy: CODICE CIVILE art. 2488.

¹⁰² Betriebsverfassungsgesetz § 77 (Hereinafter cited as BetrVerfG).

¹⁰³ Belgium: C. Com. I-IX, art. 134.

France: Law of 1925, art. 32.

embourg sets no statutory size limit to the companies which may use the single-manager system: perhaps size limits in Luxembourg are imposed by geography.

The weight which should be given to these personnel requirements varies somewhat among the countries. A few officers, like the executives (*Direktoren*) in a German stock company, cannot be removed from their position without proof of unfitness for the office. Most officers—including the members of the highest governing boards in France and Germany (*conseil d'administration, conseil de surveillance, Aufsichtsrat*) are removable at the pleasure of the shareholders.¹⁰⁴ As to officers of the latter type, the investor can if necessary authorize his European counsel to fill the positions with docile individuals who will vote as instructed, and resign when requested; that is, with "dummy directors." Certainly the difficulty of filling positions should not stand in the way of selecting a form of organization which is strongly indicated by the financial requirements of the enterprise. But, other things being equal, useless cogs in the administrative machinery are to be avoided for the same reason as are useless parts in the power plant.

g. Labor Representation

In Germany a unique factor favoring the limited liability company is encountered. In every stock company, regardless of size, one-third of the supervisory board members (who choose the executives) must be labor representatives. This requirement does not affect limited liability companies until they have 500 or more employees.¹⁰⁵

h. Privacy

A few American investors may also be attracted to the limited liability company by the greater financial privacy permitted in some countries. In Germany and Luxembourg stock companies must publish their annual financial statements,¹⁰⁶ while limited liability companies do not have to. But the resulting disclosure is no greater, and usually less, than unlisted American corporations' statements in Moody's or Standard and Poor's.

¹⁰⁴ For a fuller discussion of "governing boards" see the next part of this chapter, under the title "Management of a European Subsidiary."

¹⁰⁵ BetrVerfG § 77.

¹⁰⁶ Germany: AktG § 143.

Luxembourg: Company Law art. 75. In France, the duty to publish financial statements falls only on those stock companies which are listed on a stock exchange. Ord. 59-247, Feb. 4, 1957; J.O. Feb. 8, 1959, p. 1754; L'ACTUALITÉ JURIDIQUE 1959, III. 62.

i. *Other Advantages*

There are other advantages in the limited liability company form which contribute to its popularity among small businessmen in Europe. One of these is a smaller minimum capital; in Germany a stock company must have minimum capital of about \$25,000, while \$5,000 will do for a limited liability company.¹⁰⁷ Another is the simplicity of the papers to be filled out; they are such that a European businessman may feel safe in preparing them without a lawyer. Some laws permit publishing an extract of limited liability company articles, while stock company articles must be published in full at greater expense. These advantages will not be of much interest to American investors in Europe; they are pin-prick in relation to the major expenses and difficulties inherent in a trans-Atlantic plunge.

3. TRANSFORMATION

The choice between stock company and limited liability company, once made, is not irreversible. In each country which offers the choice, there is also a procedure for changing from one to another, called "transformation."¹⁰⁸ Like incorporation, it involves drawing up new articles, and depositing and publishing various copies or extracts; the expenses are probably about the same as for incorporation.

However, transformation is not necessarily a "tax-free reorganization," in the American sense. In Belgium and Germany, at least, it is viewed under tax laws as a sale of assets unless it comes within certain strict limitations. If it is not within these limits, it incurs transfer taxes based on the value of the assets transferred, and income tax on previously unrealized or unreported gains. In Germany, the limits are fairly wide; it is sufficient that both companies (the submerging, and the emerging) are German, that 100% of the assets pass in exchange for stock in the new company and that the

¹⁰⁷ AktG § 7 (100,000 DM minimum for a stock company), GmbHG § 5 (20,000 DM minimum for a limited liability company).

The minima are even lower in other countries; Italy requires 1,000,000 lire (about \$1500) for a stock company and 50,000 lire (about \$75.00) for a limited liability company. C. Civ. art. 2327, 2474.

¹⁰⁸ Belgium: The procedure is nonstatutory.

France: Law of 1925, art. 21 (*Transformation*).

Germany: AktG §§ 264-277 (*Umwandlung*).

Italy: CODICE CIVILE art. 2498 (*Trasformazione*).

Luxembourg: Procedure is nonstatutory.

book entries be such as to negate any concealment of tax liability. In Belgium there is no statutory exemption, but only a practice of the treasury not to claim taxes in those cases in which both the members and the assets of the company remain the same after the transformation as before. In France, on the other hand, transformation seems to be tax-free by general rule.

We understand that the burdens and risks of transformation are enough to deter the ordinary incorporator from forming a limited liability company with the intention of transforming it to a stock company a few years later, or vice versa. The form is chosen for "keeps," although later events sometimes lead the choosers to reverse their original choice. The situation is not like that of England or the United States, where every company is born as a "private company" or "close corporation," and becomes a "public company" or corporation of "public issue" by virtue of later acts. In Europe, it is usual for the lawyer to attempt to foresee the ultimate character of the enterprise, and to incorporate in the form which is appropriate to that ultimate character.

C. THE CHOICE OF A STATE OF INCORPORATION

I. THE DETERMINING FACTORS

One of the features of European incorporation which differentiates it most sharply from incorporation in the United States is the absence of freedom of choice of the state of incorporation. The European lawyer who is forming an operating company does not incorporate in the country whose tax or corporation laws are most favorable, without regard to where the company's headquarters are going to be. His choice is already made by the client who has decided, for other reasons, where he wants to locate the "central office" of the business.¹⁰⁹

The reasons for this absence of freedom are connected with two rules of law. One of these is a rule found in the corporation statute for each country, which provides that the articles must designate a central office (*siège, Sitz, sede, zetel*) which must be, at least inferentially, in that country.¹¹⁰ In this respect they differ from the

¹⁰⁹ I adopt for use in comparative law the term employed by RABEL, 2 CONFLICT OF LAWS 31 ff. (1947). Since this concept is not used in Anglo-American law, there is no precise legal parallel, although it is much like the "home office" of an insurance company.

¹¹⁰ All the laws require that the articles of incorporation be filed at the commercial court or commercial registry, or both, of the district in which the company has its

Delaware act, which requires designation only of "the principal office . . . within this state,"¹¹¹ or the Illinois act, which calls for "the address . . . of its initial registered office in this State."¹¹² A classic view among European theorists is that if the actual central office is in a country other than that of the office designated in the articles, the company is in violation of its charter, and is exposed to various undesirable (if unspecified) consequences.¹¹³ A few contemporary writers have questioned whether there are really any serious consequences to be feared,¹¹⁴ and a Dutch authority declares that the Dutch Minister of Justice often ignores known violations of the rule.¹¹⁵ The Italian law specifically permits a company to adopt, *by amendment*, of its charter, a foreign central office.¹¹⁶ But in companies other than the Netherlands and Italy, an American-owned enterprise would be unwise to make a deliberate test of the rule.

The second rule which inhibits freedom of choice of place of incorporation is a rule of conflicts of laws. According to prevailing European opinion, a corporation's internal affairs and its legal existence are governed by the law of the place where the central office is located.¹¹⁷ This seems to mean the actual central office, not a

"central office," in terms which leave no doubt that a court or registry in the country of the legislator is intended. See, for instance:

France: Law of 1867 art. 55.

Germany: AktG § 28.

The Netherlands law specifically states that the central office (*plaats van vestiging*) must be within the Netherlands. W. K. art. 36c. There are exceptions in the Netherlands and elsewhere, enacted in contemplation of enemy occupation, which permit temporary removal of the central office for emergency reasons which will not enter into the planning of American investors.

¹¹¹ General Corporation Law of the state of Delaware § 102(g) (2). The wording admits the possibility of other "principal offices" in any number of other states.

¹¹² Illinois Business Corporation Act. § 47b, ILL. STAT. ANN. § 157.47(b) (Smith-Hurd, 1954).

¹¹³ RIPERT, *TRAITÉ ÉLÉMENTAIRE DE DROIT COMMERCIAL* 268 (France 1954).

VON GODIN-WILHELM, *AKTIENGESETZ* § 5, Anmerkung 6 (Germany).

KOLLEWIJN, *AMERICAN-DUTCH PRIVATE INTERNATIONAL LAW*, No. 3 *Bilateral Studies in Private International Law* 16 (1955). Kollwijn is somewhat sceptical of this view, but recognizes it as "prevailing."

¹¹⁴ See BEITZKE, *JURISTISCHE PERSONEN IM INTERNATIONAL PRIVATRECHT UND FREMDEN-RECHT* 104 (Germany 1938).

¹¹⁵ See Kollwijn, *op. cit. supra* note 54, at 16.

¹¹⁶ C. Civ. art. 2437.

¹¹⁷ RABEL, 2 *CONFLICT OF LAWS* 33-37 (1947).

BATIFFOL, *TRAITÉ ÉLÉMENTAIRE DE DROIT INTERNATIONAL PRIVÉ* 232, 453 (France 1955).

WOLFF, *DAS INTERNATIONALE PRIVATRECHT DEUTSCHLANDS* 115 (Germany 1954). Kollwijn *op. cit. supra* note 113, at 16.

This view was crystallized in a uniform law contained in a treaty signed by the Benelux countries, but which never came into effect because it was never ratified by

fictitious one stated in the articles. This contrasts with the prevailing American rule that the corporation's existence and internal affairs are governed by the state of incorporation, wherever it may establish its central office.¹¹⁸ Following this theory it is said that a company which is organized under the laws of one country, and then sets up a central office in another, is invalid at the situs of its central office, because it has not organized in accordance with the laws prevailing there.¹¹⁹

Professor Ernst Rabel, discussing this question in terms of a Delaware corporation doing business in Europe, declared:

A corporation constituted in Delaware with headquarters in Amsterdam will be considered subject to Dutch law on the whole European continent, and therefore on principle as non-existent. . . .

While the essence of the rules has often been misunderstood especially in the English literature and by German writers too, the policy behind the rules has not always been appreciated. The most important viewpoint from which to consider the rule is of a state that does not want an organization to establish its principal office in its territory and yet derive its existence and legal character from a foreign state. Thus, in the oldest decisions of the German Supreme Court on this matter, a company incorporated in the state of Washington, United States, for the purpose of exploiting Mexican mines, but which was controlled by a board of directors in Hamburg, Germany,

the Netherlands, as the Hague Treaty of May 11, 1951. It stated in Article 3, "The existence of a legal person and its organs or representation shall be determined by the country of its seat. . . . For the purposes of this Article, an artificial person shall be considered to have its seat at the place where its central control is located."

These provisions, which have no legal force, are regretted by Kollwijn. According to our informants, these provisions are a major obstacle to ratification, and may be dropped.

The rule that the company is governed by the law of its central office is apparently codified by the laws of Belgium and Luxembourg, both of which provide in identical terms that "every company whose principal establishment is in Belgium (in the Grand Duchy) is subject to the Belgian (Luxembourg) law, even if the incorporation took place in a foreign country." Belgium: C. Com. I-IX art. 197;

Luxembourg: Company Law art. 159. This seems to be understood as referring to the central office, rather than to the site of exploitation.

Italy: The code declares that all companies are subject to Italian company law if they have their central office or principal activity in Italy (C. Civ. 2505), although inconsistently declaring that Italian law applies to companies formed in Italy, but active principally abroad (C. Civ. 2509). See also Loussouarn, *Droit International du Commerce*, REVUE TRIMESTRIELLE DE DROIT COMMERCIAL 246, 250 (1959), commenting on art. 58 of the Treaty of Rome.

¹¹⁸ RESTATEMENT, CONFLICT OF LAWS §§ 155, 182 ff.; RABEL, *op. cit. supra* note 109, at 31.

¹¹⁹ Wolff, *op. cit. supra* note 117, at 115-116.

was denied recognition as an American legal entity; having failed to fulfill the German requirements for incorporation, it was treated as a German non-corporate association. When a domestic company transfers its domicile to a foreign country, it loses its personality.¹²⁰

In the view of our Dutch collaborator, Professor Rabel's choice of Amsterdam as a hypothetical site was unfortunate. Mr. Deelen concurs in Kollewijn's view with respect to a corporation formed under foreign law but having its actual central office in Holland, that

It is out of the question that a Dutch judge would ever, on this sole ground (there being no fraud or public policy considerations) declare a corporation null and void, and no decision to that effect has ever been rendered.¹²¹

Conversely, he believes that corporations could be formed in the Netherlands, and operate their affairs from headquarters in Germany or France without objection from the Dutch government or courts.

However, an investor cannot safely take advantage of this Dutch liberalism unless he is assured of equally tolerant views in the neighboring countries in which the other part of the play would have to be acted. Despite intimations of similar tolerance by occasional writers in other countries,¹²² the weight of authority (and of our collaborators) cautions against experimenting with these rules of law. The safe course is to organize where the central office is to be, and to centralize management unambiguously at that office.

Although there is no freedom to choose a state of incorporation which is different from the state of the central office, there is no prohibition against choosing a central office location which is outside the country of the principal business operations.¹²³ For instance, a company could establish its main office in Luxembourg, although its principal business consisted of exploiting coal mines in the Netherlands or operating steel mills in France. The "central" office is

¹²⁰ RABEL, *op. cit. supra* note 117, at 37-39.

¹²¹ Kollewijn, *op. cit. supra* note 113, at 16.

The result seems to be precluded also by the Netherlands-U.S. Treaty of Friendship, Commerce and Navigation, which provides in Article XXIII, § 3, that "Companies constituted under the applicable laws and regulations within the territories of either party shall be deemed companies thereof, and shall have their juridicial status recognized within the territories of the other party." T.I.A.S. 3942.

¹²² E.g., Beitzke, *op. cit. supra* note 114.

¹²³ Ripert, *op. cit. supra* note 113, at 396.

Battifol, *op. cit. supra* note 117, at 232.

Wolf, *op. cit. supra* note 117, at 115.

Rabel, *op. cit. supra* note 117, at 40.

identified by reference to activities of management and supervision, rather than activities of manufacture and sale.¹²⁴

According to our information, little use is made, and little should be made, of this technical freedom. It is quite unlike operating a Hoboken refinery from a Manhattan executive office, because there are between any two European countries a flock of actual or potential barriers which have not existed since 1865 between American states. There are passport clearances impeding travel from one to the other, differences of currency, possible exchange restrictions, and customs (until 1972). All these barriers impede the intimate contact between management and operations which is just as essential to optimum efficiency in Europe as it is in the United States.

There is another reason for not separating management from operations which is peculiarly European. European managers with whom we have spoken emphasize the necessity of constant contacts with government, since price changes, wage changes, and major building programs must frequently be approved by an official of a national ministry. It is reliably reported that the notoriously uneconomic concentration of French industry in the Paris area is influenced by the need of managements to be simultaneously near their plants and near their ministers.

Consequently, it is unlikely that a company organized to mine or manufacture solely in France would locate its central office in Germany or vice versa. However, if a single company were formed to mine and manufacture in both France and Germany, it might locate its central office in either of the countries, and would not need to move because the activities in the foreign country grew larger than those in the country of the central office. Or it might choose a central office in Luxembourg, which is between the major countries.

2. THE "DELAWARES OF EUROPE"

If we may judge from our conversational contacts, the views expressed in the preceding paragraphs will surprise many American lawyers, who have been told that Lichtenstein or Switzerland or Luxembourg is the "Delaware of Europe."

Such metaphors convey more falsity than truth. In so far as they suggest that these countries furnish a convenient place for incor-

¹²⁴ Loussouarn, in *Les Conflits de Lois en Matière de Sociétés* 135 (1949) contends that a central office which did not coincide with any important operations would be presumptively fraudulent.

porating a company which will have its central office and principal operations in other countries, they are false both in law and in practice. None of these countries is commonly used, or could be advantageously used, for such purposes, for the reasons already given.

A second connotation of such a metaphor might be that the laws of these countries permit great freedom in financial operations, for instance, the payment of "nimble dividends" when capital is impaired, or the assignment of most of the share consideration to surplus which can be freely paid out as dividends. These suppositions would also be baseless, at least as to Switzerland and Luxembourg.

Or it might be supposed that these countries have lower incorporation fees than neighboring countries, as Delaware's franchise tax is lower than that of most industrial states. We do not have complete information on the incorporation fees in these countries, but we understand that incorporators are not drawn to them by cost advantages of this kind.

However, it is true that certain investors have sought out these countries as places in which to incorporate and manage their companies, in preference to neighboring countries; but the companies so formed have been, in almost all cases, holding companies, not operating companies. They have been truly localized in the country of incorporation, because their securities are kept there.

D. THE EUROPEAN LAWYER'S ROLE IN INCORPORATION

The procedures of incorporating in the countries of the European Common Market are basically like procedures in the United States. They start with some rather mechanical documents, filled with the proper number of names and addresses, indications of the corporate purposes, statements of kinds and amounts of capital stock, and a good many paragraphs about directors and officers, their powers and their pay. The papers must be filed, some sort of publication made, fees paid, organization meetings held, and certificates of completion of one or another formality carefully executed.

In Europe, as in the United States, these formalities are for the local practitioner. There is no point in the American investor's learning their details, because he cannot perform them anyway. Hence, we do not present checklists of incorporation steps.

What the American investor can do is to make an intelligent selection of a European practitioner, explain his general objectives, and review the documents which the practitioner proposes to file and

publish. The following observations explain some of the differences in European practice which an American investor will encounter in his dealings with European legal representatives.

I. THE ADVOCATE

The American who looks around the Common Market for a "corporation lawyer" encounters a puzzling situation. It is difficult to find any expression in any of the four languages involved which would accurately translate the term "lawyer,"¹²⁵ much less the term "corporation lawyer."

The American may, however, ask for a "member of the bar," and be led without hesitation to an "advocate" (*avocat*, *Anwalt*, *avvocato*, *advocaat*). The advocate is primarily a courtroom lawyer and is often compared to the English barrister.¹²⁶ But, unlike the barrister, he does not have to be approached through a solicitor, nor does he expect the facts to be gathered and the case appraised before it comes to him. Perhaps the advocate is best explained by saying that he is like one of the great general practitioners of America's nineteenth century, who could try a tort case, argue a constitutional law appeal, and advise a corporation on its tax liability, all without partners or junior associates.

Many European advocates, including some of the very best, are solo practitioners, except as they may have apprenticed assistants. In France group practice among advocates was forbidden until 1954.¹²⁷ Since solo practitioners are not likely to be highly special-

¹²⁵ See BURDICK, *THE BENCH AND BAR OF MANY LANDS* (1939), for general observations on the legal professions in Germany, France, and Italy. For France, see Lepaulle, *Law Practice in France*, 50 COLUM. L. REV. 945 (1950); Brown, *The Office of Notary in France*, 2 INTERNATIONAL AND COMPARATIVE LAW QUARTERLY 60 (1953); Tunc, *Modern Developments in Preparation for the Bar in France*, 2 J. LEGAL EDUC. 71 (1949-50); Simmons, *French Lawyers' Special Fields*, 30 TULANE L. REV. 101 (1955). For Germany, see Weniger, *The Profession of the Bar in Germany*, 34 ILL. L. REV. 85 (1939-40). For Italy, see Sereni, *The Legal Profession in Italy*, 63 HARV. L. REV. 1000 (1950).

The plurality of possible interpretations is illustrated by the fact that Frenchman Tunc (above) treats *avocats* and *avoués* as the only classes of French lawyers, while Frenchman Lepaulle (above) described *avocats*, *avoués*, *notaires*, and *agents d'affaires* as varieties of "lawyers."

¹²⁶ For instance, by Brown and by Tunc (see note 125 *supra*). With respect to France, there is some point in the barrister-advocate comparison because neither has power to "represent" (*i.e.*, make binding agreements for) his client; that belongs to the solicitor in England and the *avoué* in France. But the comparison may prove misleading, since the French advocate does not have to be briefed by a solicitor (as the English barrister does), and cannot file written pleadings (as the English barrister can).

In other countries, the advocate *may* bind his client.

¹²⁷ HAMELIN, *ABRÉGÉ DES RÈGLES DE LA PROFESSION D'AVOCAT* art. 207 (1954), citing decree of April 10, 1954, art. 49.

ized, in corporate matters, many advocates will not draft the incorporation papers in their own offices. Some, of course, will do so. Others may accept the responsibility, but delegate the work to an outside office to prepare the documents—especially if the American client seems to expect that the advocate should himself produce the papers. An equally normal procedure, in most of the Common Market countries, is for the advocate to discuss the principal problems, advise the client on some of the preliminary questions (what form of company, where to incorporate, what kind of management structure) and then send the client on to a notary to get the drafting done. In some of the German states (*Länder*) the offices of advocate and notary are combined; in these states it is most probable that an advocate will be found who is both a counselor on corporate matters and a draftsman of corporate documents.

2. THE "ATTORNEYS-OF-RECORD"

In France there is a special kind of lawyer called an "*avoué*"—a title whose etymological connotations recall the English "attorney." We mention the *avoué* only because the identification of French "advocates" with English "barristers" leads so easily to the identification of French *avoués* with English "solicitors."¹²⁸ Since a prospective American investor in England would properly consult an English solicitor, the conclusion might be drawn that an American investor in France should consult a French *avoué*.

Nothing could be further from the mark. The job of the *avoué* is to appear of record for a litigant, to file written pleadings, to receive notices, and to make on behalf of the client any commitments and elections which are incident to the procedure of litigation. The pleadings which are filed by the *avoué* may be drawn either by himself or by the advocate, but oral advocacy is the job of the advocate. An American translation for this peculiar intermediary might be "attorney-of-record."

These functions of this "attorney-of-record" are much like some of those performed by an English solicitor. But the French "attorney-of-record" performs none of the functions of business counseling, property management, and drafting of non-litigious documents, which probably occupy the larger part of an English solicitor's

¹²⁸ The distinguished comparatist Tunc compares them for certain purposes. *Op. cit. supra* note 125, at 71, n. 1. Tunc emphasized that the French *avoué*, like the English solicitor, has the power to "represent" his client.

time, and which qualify him to advise an American investor. Most of these functions are performed in France chiefly by notaries.¹²⁹

The "attorney-of-record" is a professional who is peculiar to France, and is not even found in all districts of that Country. There is some recognition in other countries of the attorney-of-record's distinct functions, but they are generally performed by a person who bears the title of "advocate."^{129a}

3. THE NOTARY

The European notary is also a lawyer.¹³⁰ That is, he is a man who has a university law degree, or who has at least passed professional examinations for his position, and who makes his living strictly by professional work. But he generally does not appear in court, except when, as in some German states, he is also an advocate. Since notaries handle almost all aspects of the administration of decedents' estates, marriage settlements, and conveyances of real estate, they might remind an Englishman of a family solicitor; an American colleague might call them "office lawyers." But the European notary has a dignity which distinguishes him from either an English solicitor or an American lawyer. Like an American justice of the peace, he exercises a public trust, even though his income depends on private fees. He holds an "office" which he has either inherited from an ancestor or purchased at a high price, and he is a custodian of records of property ownership. When he takes acknowledgments of documents, he is not satisfied by knowing that the signature is genuine; he will read or explain the entire document to the client, and refuse to take the acknowledgment unless he is quite sure that the client understands every line. In fact, the notary is normally the draftsman of documents whose acknowledgments he takes.¹³¹

Urban notaries frequently become specialists in corporate prac-

¹²⁹ Cf., Brown, *op. cit. supra*, note 125, at 60.

^{129a} In Italy, a young lawyer is first admitted to practice only as an attorney-of-record (*procurazione*), but later becomes an advocate (*avvocato*), and thereafter performs both functions. See Sereni, *supra* note 125.

In Luxembourg, most lawyers describe themselves as being both advocates and attorneys, using the hyphenated title, *avocat-avoué*.

¹³⁰ See Schlesinger, *The Notary and the Formal Contract in Civil Law*, NEW YORK STATE, REPORT OF THE LAW REVISION COMMISSION 403 (1941) (observations on France, Germany, and Switzerland).

Brown, *op. cit. supra* note 125, at 60.

¹³¹ Our Netherlands collaborator says that in his country the notary invariably drafts any instrument which is required to be notarized.

tice. It is no accident that some of the best French treatises on company law have been written by the editor of the "Notaries' Journal." ¹³²

4. UNLICENSED LAWYERS

Various classes of people who are not members of any legal profession, and perhaps not of any licensed profession, also participate actively, competently, and lawfully in advising on incorporation problems. Frequently tax problems are important, and these will probably be referred by lawyers or notaries to tax specialists, who are not usually lawyers; they are sometimes, but not necessarily, accountants.

Accountants may also assume the main work of planning the corporate organization and drawing the papers; an Italian advocate has advised us that his accountant competitors are perfectly competent in corporate matters, while another doubts it.

There are also, at least in France, wholly unlicensed business agents (*agents d'affaires* or *conseillers commerciaux*) who will undertake to arrange an incorporation, acting partly as advisers and partly as intermediaries for notaries and tax specialists who may be needed. ¹³³

Some of these unlicensed advisers have organized themselves into an association of "company legal advisers" (*conseils juridiques de sociétés*). The existence of these unlicensed operatives in a semi-legal field seems to be an indirect result of the fractionation of the French legal profession in terms of formal procedures—formal appearance and filing of written pleadings (by the *avoué*), ¹³⁴ oral argument (by the *avocat*), and drafting of nonlitigious documents (by the *notaire*). As an incident of this fractionation, counseling has become nobody's profession.

This interesting lacuna in French professional regulation explains the role of the many American lawyers in Paris who have no license for any kind of practice in France. So long as they only give advice, referring formal procedures to licensed attorneys-of-record,

¹³² Moreau, Editor-in-chief of the JOURNAL DES NOTAIRES, is the author of LES SOCIÉTÉS CIVILES (France, 1954), LA SOCIÉTÉ ANONYME (France, 1948), LA SOCIÉTÉ À RESPONSABILITÉ LIMITÉE (France, 1952).

¹³³ See Lepaulle, *op. cit. supra* note 125, at 947; Simmons, *op. cit. supra* note 125.

¹³⁴ In discussing French procedure (in English) one must distinguish between the written contentions, technically called "pleadings" in Anglo-American law (see BOUVIER, LAW DICTIONARY, tit. "Pleading"), and oral persuasion, colloquially called "pleading." Confusion is promoted by the cognation of the English word "pleading" (with its two meanings) and the French *plaidoirie* (whose technical meaning is oral advocacy).

advocates, and notaries, they may lawfully carry on activities which would be considered the "practice of law" if carried on in the United States.¹³⁵

There is no doubt that some of these unlicensed counsellors are thoroughly competent, nor that there are some who are not. One can only say that the care which should always be used in selecting a professional adviser is even more vital if an unlicensed one is chosen.

5. WHICH KIND OF LAWYER?

The only professionals whose participation is required by law for a European incorporation are the notaries. They are needed for the execution of articles of a stock company in every country but France;¹³⁶ and they are necessary in France to complete the company organization.¹³⁷ In the formation of limited liability companies they are required in Belgium, Germany, and Italy,¹³⁸ but not in France and Luxembourg.

Experienced European businessmen frequently use no more outside professional service than the law requires. They incorporate without the advice of an advocate, and use a notary only in the situations where the law requires it. They do not consult an advocate, an accountant, or a tax specialist, unless the incorporation presents unusual technical problems.

American investors, on the other hand, have generally consulted European advocates, and obtained through them such services as might be needed from notaries, accountants, and tax specialists. Perhaps this has frequently been done under a belief that an advocate, like an American lawyer, is the only qualified adviser on

¹³⁵ An English solicitor and law teacher, Mr. L. Neville Brown, informs us that in England also "the lawyers' monopoly . . . has been eaten away as far as counseling in tax and corporation matters is concerned by the professional accountant and various business consultants. . . ."

¹³⁶ Belgium: C. Com. I-IX, arts. 29, 31, 33.

Germany: AktG § 16. The law requires notarial *or* judicial execution; but notarial is the practical choice.

Luxembourg: Company Law arts. 26 and 30.

Netherlands: W.K. art. 36.

¹³⁷ The cash subscriptions must be originally paid in either to the National Deposit Bank (Caisse de dépôts et consignations), or to a notary; when the required fraction of subscriptions has been paid in, the proceeds can be released to the company officers only on a notarial affidavit that the conditions have been fulfilled. Law of 1867, art. 1. We are advised that the simpler and most preferred procedure is to use a notary for both functions.

¹³⁸ Belgium: C. Com. I-IX art. 4.

Germany: GmbHG § 2.

Italy: CODICE CIVILE art. 2475.

corporate matters. Although such a belief would be false, the practice of consulting an advocate is probably sound. It is safe to say that a European investment by an American enterprise *always* involves problems which are unfamiliar to the investor. It seems to be the European consensus that the advocate is the professional most likely to have a sound perspective concerning the ensemble of problems likely to arise, and the one best qualified to draw in others' talents.

With this comment we would like to pass on two warnings from our European informants. The American investor should not expect his advocate to produce in his own office all the expertise and the documentation required; he should be prepared to have the advocate draw on other professionals or to send the American to them.

It should also be clear that the American does not always need a European advocate. If he is reliably referred to a French or German notary, it is probable that the notary is just as competent as any advocate to decide when other professional collaboration is called for. Likewise, an American lawyer practising in Europe (without a European license) may be perfectly competent to supply the perspective which is commonly obtained from a European advocate, and to call on the other professionals (notaries, tax specialists) who may be useful.

E. THE ORGANIC DOCUMENTS

I. DRAW THEM IN EUROPE!

The late Professor Ascarelli once remarked that it is of secondary importance whether the American investor asks an advocate, an accountant, or a notary to draw his European articles of incorporation. The thing of primary importance, he said, is this: *don't* draw the articles in New York and send them to Rome or Hamburg. Not only are such articles invariably far from the demands of local law and practice, but they impose on a European lawyer an impossible job of explaining to the American client why they must be changed. What the American client should send to Rome or Hamburg is a statement of what activities he wants to conduct, where he expects to get his money, whom he expects to employ as managers, and other information on operational plans; the drafting he should leave to the European adviser.

In the light of this advice—which appears to us to be very sound

—there is not much to say on this side of the water about the organic documents. We will offer a few observations designed chiefly to improve communications between transatlantic and cisatlantic lawyers.

2. ARTICLES AND BY-LAWS

One does not, of course, ask a European lawyer to prepare a set of articles and by-laws. The Europeans do not use these two sets of organic documents; their functions are combined in one document.

Telling him to draw a set of "articles" may also contain elements of confusion; the more English he knows, the more likely he is to be confused. For instance, he may know that the basic document in Delaware and New York is called the "certificate of incorporation," and in England (from which many Europeans surprisingly take their English), "memorandum of association." What then are "articles of incorporation?" It may be helpful to have at hand some European names of the formative documents—*acte constitutif*, *Gründungsvertrag*, *atto costitutivo*, *akte van oprichting*.

These European names are not the end of the matter, either. We have in America one set of names for the basic document, when we think of it as something signed and filed during the formative process of the corporation; these are "certificate of incorporation" or "articles of incorporation" (varying by jurisdiction). We have another set which we use after the corporation has been fully organized, to refer to the *contents* of the document, and to include amendments to it; thus we speak of the limitations of the "charter." Likewise Europeans have a set of names which signify the organic law of the company, as derived from the articles and amendments. The principal terms are *statuts*, *Satzung* or *Gesellschaftsvertrag*, *statuti*, and *statuten*.¹³⁹

Many of the elements found in European articles of incorporation are the same as those in American articles. They indicate the statutory type of company (stock or limited liability), the purpose, the name, the duration, and the amount of capital.¹⁴⁰ In all limited

¹³⁹ *Gesellschaftsvertrag* is generally applicable to all commercial companies, including stock companies, limited liability companies, and partnerships. *Satzung* is a special name for the *Gesellschaftsvertrag* of a stock company (used also for the partnership limited by shares, *Kommanditgesellschaft auf Aktien*). See, for instance, usage in HUECK, *GESELLSCHAFTSRECHT* 24, 116 (1958).

¹⁴⁰ For the principal statutory sections on contents of the articles of incorporation see the following:

Belgium: C. COM. I-IX, art. 30 (stock companies); arts. 120-121 (limited liability companies).

liability companies, and in stock companies except in France, the incorporators are named in the articles. To the practiced American eye, nothing essential is lacking except that the purpose clause is much shorter.

3. PURPOSE CLAUSES

There are considerable variations in the laws and practices of the various countries with respect to purpose clauses. The law and practice in France is liberal. A popular form book advises the incorporator, after stating the objects which he has in mind, to add as additional objects,

Investment by the company, by any form or means, in any business and any company now existing or which may come into existence.

And all industrial operations in general.¹⁴¹

Professor Houin considers this bad practice, but notes that it is widely followed, and that the undesirable consequences are uncertain.

While this approach will remind an American lawyer of some of the clauses seen in Delaware and other American charters, there is an important difference. One never encounters the three-page list of purposes and powers which are customary in Delaware, and often used in other American states, and any European lawyer would probably resist any suggestion that he imitate it. There are at least two reasons. One is that the law authorizes the articles to state *purposes*, not *powers*. The other is that the ultra vires doctrine, whose ravages in the United States brought forth the inflated American purpose clauses, never received such extreme applications in countries of Europe.

Broad purposes clauses are apparently tolerated also in Germany, Italy, and Luxembourg, so long as some real purpose exists.¹⁴² In two nations—Belgium and the Netherlands—vague or omnibus purpose clauses are inadmissible. The Belgian company law was

France: Law of 1867 art. 1 (S.A.), Law of 1925 art. 14 (SARL).

Germany: AktG § 16, GmbHG § 3.

Italy: CODICE CIVILE art. 2328 (S.p.A.), art. 2475 (SARL).

Luxembourg: Company Law art. 27 (S.A.), art. 184 (SARL).

Netherlands: W.K. arts. 36b, 36c, 36d.

¹⁴¹ LEMEUNIER, POURQUOI ET COMMENT CONSTITUER UNE SOCIÉTÉ ANONYME p. I-7 (1958).

¹⁴² Our German collaborator warns that a company might be successfully attacked

amended in 1958 to require a "precise designation of the purpose of the enterprise."¹⁴³ In the Netherlands the Ministry of Justice is likely to refuse a permit to incorporate if the declared objects go beyond the potential of the company's capital.

4. RULES OF INTERNAL GOVERNMENT

Any brevity which European articles acquire through the shortness of their purpose clauses is soon lost by the length of their provisions for internal government. The articles contain innumerable details on shareholders' meetings—when they are held, how they are called, who may be admitted, how the agenda is made up, how minutes are kept, how votes are counted. Many of these provisions will be found to restate propositions of the company law of the particular country. These portions of the articles are much like the by-laws of a typical American corporation.

It is obviously inconvenient to have to include all this material in the formally filed articles; it is of no interest to the state, or the creditors, or anyone other than the shareholders. But since there is only one organic document in European company law, these necessary provisions must be put in it.

The burden of including these internal matters in the articles is recognized by some of the publication laws. In France and Germany publication is required only of an extract of the articles; the extract corresponds roughly to American articles, and excludes most of the "by-law" items.¹⁴⁴ In Belgium the extract procedure is used for limited liability companies,¹⁴⁵ but not, unfortunately, for stock

if it were formed without any specific purpose in mind, but merely to serve some later need which might appear; that is *Gesellschaft auf Vorrat*.

¹⁴³ C. COM. I-IX, art. 30 (1), as amended by Law of January 6, 1958.

¹⁴⁴ France: The extract for the *société anonyme* requires: (1) type of company (*e.g.*, stock company or limited partnership with shares); (2) name; (3) purpose; (4) central office; (5) names and addresses of members; (6) names of managers and auditors; (7) amount of capital, value of shares, and description of property (if any) exchanged for shares; . . . (9) provisions (if any) for special reserves; (10) whether there are any shares with double vote, or any founders' shares; (11) when the company begins and expires; (12) the court in which the complete articles and other documents were filed. Law of 1867, art. 57. The extract for the SARL is substantially the same. Law of 1925, arts. 13 and 14.

Germany: The extract for the stock company must contain the company name, central office, purpose, date of organization, names of managers, and also (if applicable) any provisions which may exist limiting the duration of the company, or limiting the agency powers of the managers or liquidator, or limiting the "authorized" capital. AktG. § 32. The limited liability company extract is similar. GmbHG § 10. The cited sections refer to the entries in the Commercial Register, but these entries must be published by the court, by virtue of HGB § 10.

¹⁴⁵ C. COM. I-IX, art. 7(b). The Belgian publication requirement includes two items

companies.¹⁴⁶ Italy, Luxembourg, and the Netherlands require publication of complete articles in all cases.¹⁴⁷

F. INCORPORATORS

One of the striking peculiarities of European incorporation, from an American viewpoint, is the insistence on numerous incorporators. The laws do not generally state a minimum number of signers of the formative documents, but they do specify the minimum number of shareholders, and European lawyers generally conclude that the full benefits of incorporation are not attained until that number of shareholders exists. For stock companies, the minimum number is seven in Belgium, France and Luxembourg,¹⁴⁸ and five in Germany.¹⁴⁹ In Italy and the Netherlands two will suffice for a stock company,¹⁵⁰ and two will do for a limited liability company in all the countries where such a company may be formed.¹⁵¹ But no member of the Common Market has followed the example of a few American states which permit a single investor to incorporate.¹⁵²

Requirements of this sort give little difficulty to an American lawyer on his home grounds; any group of clerks will do for incorporators, and shares can be subscribed and paid for in their names. But many European lawyers will object to this kind of practice. Our Belgian, French, and Dutch collaborators all warn against the unpleasant legal consequences which might result from procedures of this sort; only the German colleague sees no problem.

which would probably be found in American by-laws—the fiscal year, and the date of the annual shareholders' meeting.

¹⁴⁶ C. COM. I-IX, art. 9.

¹⁴⁷ Luxembourg: Company Laws art. 8.

Netherlands: W.K. art. 367.

¹⁴⁸ Belgium: C. COM. I-IX, art. 29.

France: Law of 1867, art. 23.

Luxembourg: Company Law art. 26.

¹⁴⁹ AktG § 2.

¹⁵⁰ Italy: CODICE CIVILE art. 2247.

Netherlands: No statutory provision requires more than one member; but all sections speak of the members in plural terms, and Dutch legal theory regards incorporation as a group action (our Dutch collaborator uses the German term *Gesamtakt*) which requires more than one participant.

¹⁵¹ Belgium: C. COM. I-IX, art. 119.

France: Law of 1925, art. 5.

Germany: GmbHG § 2.

Italy: C. CIV. art. 2247.

Luxembourg: Company Law art. 183.

¹⁵² IOWA CODE § 491.2 (1958).

KENTUCKY REV. STAT. § 271.025 (Baldwin's, 1955).

MICH. COMP. L. § 450.3 (1948), MICH. STAT. ANN. § 21.3 (1937).

Our Luxembourg collaborator, while disapproving the use of straw incorporators, reports that this is the usual thing in foreign-owned companies, especially holding companies.

The precise nature of the dangers incurred by using straw incorporators are not very clear. One of the consequences is said to be liability for losses occasioned by the pretense; but if the straw man's subscription is actually paid, there would seem to be no loss. In Belgium a statute provides that shareholders are liable for debts of the company until the required complement is reached.¹⁵³ Our Belgian collaborator warns that the straw man commits a crime by falsely representing himself to be a subscriber, which he is not;¹⁵⁴ but admits that the probability of prosecution is slight.

The most serious probable consequence applies only to the situation in which the various incorporators are all nominees of one investor, so that the new company is in reality a one-man company, or a wholly-owned subsidiary from its very inception. In this situation European theorists (unlike American) are inclined to regard the company as having no legal existence. One theory behind this view is the classic principle of continental law that a company is the result of a contract; and a contract with only one party is just as impossible in European law as in American.

Contemporary European jurists are well aware that the modern company is much more an institutional entity than it is a contract, and a few of them would be willing to discard entirely the contractual view.¹⁵⁵ But the contractual theory is deeply ingrained in the statutory system, and jurists cannot disregard it just because they are tired of it. In the law of France, the law of "associations" (*sociétés*), which include all kinds of business corporations, as well as partnerships and non-profit organizations, appears in the Civil Code as a subdivision of the law of contract; the French Civil Code's first words on company law are, "An association is a contract. . . ." ¹⁵⁶

Many Europeans also adhere to the view, not unheard of in

¹⁵³ Belgium: CODE COM. art. 35.

¹⁵⁴ To the same effect, see van Ryn, *op. cit. supra* note 85, at 496.

¹⁵⁵ For a comparison of contractual and institutional concepts, see Hamel and Lagarde, I TRAITÉ DE DROIT COMMERCIAL 468-469 (France 1954).

¹⁵⁶ C. Civ. art. 1832: "La société est un contrat par lequel deux ou plusieurs personnes conviennent de mettre quelque chose en commun dans la vue de partager le bénéfice qui pourra en résulter." This is the first section of Title IX—"of the Contract of Association" (*du contrat de société*). This title follows titles on sale, exchange, and bailment, and the title on loans. The same conceptual arrangement is met in the civil codes of Belgium and Luxembourg. It is only slightly different in Germany, where we need only substitute the word "obligation" (*Schuldverhältnis*) for "contract."

America, that the debt-escaping functions of a corporation can be justified only if the corporation also promotes true group activity.

For these and other reasons, European theorists are accustomed to say that a company in which there was only one bona fide investor at its inception is a nullity. The theory has been put into effect in various ways. In the Netherlands a series of tax cases attributed company income directly to the company's real owner, whose fellow-incorporator had been a mere nominee for him.¹⁵⁷ In France heirs were allowed to claim the property of a bank incorporated by their ancestor in league with straw co-investors.¹⁵⁸ In Italy a statute which makes a sole shareholder liable for the company debts incurred while he is sole stockholder¹⁵⁹ might be applied to one who holds some of the shares through straw men.¹⁶⁰

The burden of procuring incorporators who meet European standards will probably not prove very heavy. For ordinary incorporations there is no requirement that the incorporators be Europeans;¹⁶¹ they can be Americans. Neither do they have to be present; they can act by attorney-in-fact. Finally, they do not have to be natural persons; except in a Belgian limited liability company and a French stock company, all the incorporators can be corporations. Hence, an American corporation and one of its American subsidiaries could be the incorporators of a limited liability company in France, Germany, Luxembourg, or Italy, or of a stock company in Italy or the Netherlands. Seven American corporations, or seven corporations and individuals in any combination, could incorporate a stock company in Belgium or Luxembourg. Six American corporations and one individual could form a French stock company.

The test of bona fide investment is also easily met. One of our French informants, who is most positive about the danger of straw men, assures us that there is no danger in taking from each of the other incorporators a written agreement to sell his shares of stock at par on demand. A Dutch decision has held that a company was

¹⁵⁷ Decision of the Hoge Raad of Nov. 30, 1927, 3067 Weekblad vor Privaatrecht, Notaris-ambt en Registratie (hereinafter W.P.N.R.) 645 (Netherlands 1928).

Decision of Jan. 12, 1927, 3023 W.P.N.R. 850.

Decision of May 30, 1928, Beslissingen in Belasting Zaken (hereinafter B.) 4279.

Decision of April 15, 1931, B.4965.

¹⁵⁸ Court of Cassation, decision of May 19, 1926, Dalloz, Recueil Périodique et Critique, I at 25 (France 1929).

¹⁵⁹ C. CIVIL art. 2362.

¹⁶⁰ Mr. Bruna, one of our Italian collaborators, states that prevailing Italian opinion permits holding through strawmen, unless there were a subjective intent to escape obligations.

¹⁶¹ There are very few exceptions, such as, in France, petroleum extraction companies, newspaper publishing companies, travel agencies, which must have a majority of French shareholders.

not proved to be invalid merely by evidence that one of the two incorporators sold his shares to the other on the very day of incorporation.¹⁶²

We do not pretend to appraise the importance of having bona fide incorporators, or the risks of not doing so. We think, however, that the American investor should be prepared for the request that *he*, not his European lawyer, produce incorporators in the required number, and that each of these incorporators should pay separately his original subscription for shares. We have the impression that most American companies comply with this request, when made; and we think that it is wiser to comply than to become a party to a test case on an unsettled point of European law.

G. CAPITAL AND ITS PAYMENT

I. STATEMENT IN THE ARTICLES

In five of the six Common Market nations the amount of "capital" stated in the articles is quite a different thing from the "authorized capital" which is stated by the articles in most American states. "Authorized capital" means, in America, the amount which may be issued before amending the charter; some of it may not be subscribed for some time to come, and some may never be subscribed. Americans like to have a "cushion" of uncommitted stock to meet unforeseen needs.

In the Common Market (outside the Netherlands) the capital contains no uncommitted cushion. The "capital" means the *subscribed* capital, and the corporation is not fully organized until the stated amount is 100% subscribed. Some of the statutes say expressly that the company is not perfected until it reaches this point; ¹⁶³ even when the statutes are silent, the law is probably the same.

In consequence, the stated capital should be set at an amount for which present subscribers are readily available.

If the incorporators foresee that future capital demands will exceed the amount for which present subscriptions are available, they can sometimes make charter provisions for future increases by

¹⁶² Decision of the Hoge Raad of Dec. 14, 1932, B.5339.

¹⁶³ Belgium: C. Com. I-IX, art. 29 (2) (stock companies).

France: Law of 1925 art. 7 (limited liability company).

Germany: AktG § 22 (1) (stock companies).

Italy: CODICE CIVILE art. 2329 (1) (stock companies).

Luxembourg: Company Law art. 26 (stock companies), art. 183 (limited liability companies).

means simpler than getting a shareholder's vote on a charter amendment. Italy and Germany permit stock companies to adopt charter clauses which authorize the managers to increase the capital.¹⁶⁴ But the authorized increase must also be fully subscribed within a limited time—five years in Germany, one in Italy. In this respect, it is quite unlike American "authorized capital."¹⁶⁵ France also has some statutory provisions permitting "variable capital," but they are somewhat inconvenient, and are little used.¹⁶⁶ Other kinds of companies can increase their initial capital only by charter amendment; this applies to limited liability companies in all five countries, and to stock companies in Belgium and Luxembourg.

The requirement that all capital be subscribed when the company is formed does not imply that it must all be paid in at that time. All the stock company laws specify some minor fraction of the stock which must be paid in; the fraction is 20% in Belgium and Luxembourg, 25% in France and Germany, and 30% in Italy.¹⁶⁷ The limited liability laws in France and Luxembourg require payment of 100% of the amount subscribed,¹⁶⁸ but elsewhere permit the same fractional payments as in stock companies.¹⁶⁹

The fractional payment provisions are primarily directed at payments made in money. When shares are to be paid for in property, different rules may apply. French law specifically provides that payment in property must be made in full at the formation of the company,¹⁷⁰ and the Belgian law is the same.¹⁷¹ Elsewhere, the rules

¹⁶⁴ Germany: AktG § 169; The increase is limited to 50% of the stock before the increase.

Italy: CODICE CIVILE art. 2443.

¹⁶⁵ Law of 1867 arts. 48–52.

¹⁶⁶ Some of the inconveniences are that the stock cannot be made negotiable, either in bearer or registered form (art. 50), and that members can resign and withdraw their share, or be expelled (art. 52).

¹⁶⁷ Belgium: C. Com. I–IX, art. 32.

France: Law of 1867 art. 1, para. 2. The balance must be paid within five years. Law of March 4, 1943 art. 1.

Germany: AktG § 28 (2).

Italy: C. Civ. 2329.

Luxembourg: Company Law art. 26.

¹⁶⁸ France: Law of 1867, art. 3, § 4.

Luxembourg: Company Law art. 183.

¹⁶⁹ Belgium: C. Com. I–IX, art. 120. However, at least 50,000 francs (about \$1000) must be paid in, whatever fraction of the whole it may be.

Germany: GmbHG § 7.

Italy: C. Civ. art. 2476 (cross-referring to stock company requirements).

¹⁷⁰ Law of 1867, art. 4.

¹⁷¹ As to limited liability companies, full payment of property contributions is expressly required by C. Com. I–IX, art. 120.

for payments in property are no stricter than for payment in money, and perhaps less so.¹⁷²

The result of these requirements is that the capital to be stated in the articles should be determined in this way:

in a French, Italian or Luxembourg limited liability company, it should be an amount which known persons are willing immediately to subscribe and pay in full;

in a Belgian, French, German, Italian, or Luxembourg stock company, and in a Belgian or German limited liability company, it should be an amount which known persons are willing immediately to subscribe in full, and pay to the extent of 20 to 30 percent.

In stating the matter in this way, we are greatly oversimplifying the theory. In theory it is possible to have an incorporation "by stages,"¹⁷³ in which incorporators subscribe for part of the capital in the first stage, and then sell the rest of the shares through a public offering; the incorporation is complete at the end of the public offering stage. But this procedure exposes the whole venture to the danger that the public will not subscribe to 100% of the offered shares; in that event, the incorporation would collapse unless the subscribers consented to a charter amendment. As a practical matter, well advised investors seldom if ever would launch a company in this way. They might seek to avoid the risk by obtaining an investment banker to subscribe for the shares not taken by incorporators; but this stratagem is hardly practicable in a newly formed company. It may well be used in a later *increase* of capital.

The situation in the Netherlands is quite different. Only one fifth of the capital stated in the articles needs to be subscribed forthwith, and there is no time limit on subscriptions to the remainder.¹⁷⁴ Of the fifth subscribed, only one tenth needs to be paid on each subscribed share;¹⁷⁵ a company could properly carry on business with as

As to stock companies, the requirement of full payment rests on the opinions of commentators. See van Ryn and Heenen, 2 DROIT COMMERCIAL 11 (1957).

¹⁷² See GODIN-WILHELMI, AKTIENGESETZ § 28, Anmerkung 11 (1950).

¹⁷³ Known to French commentators as *fondation successive* and to Germans as *Stufen Gründung*. Special statutory provisions to deal with the phenomenon are found in the French Law of 1867 art. 4, and in the German AktG § 30.

¹⁷⁴ Netherlands: W.K. art. 36c. The subscriptions are a prerequisite to issuance of the Certificate of Incorporation, without which companies are forbidden to do business.

¹⁷⁵ W.K. art. 36g. If the amount has not been paid in, the board members are individually and jointly liable for all the debts of the enterprise. However, the company can lawfully do business without the payment if the board members are prepared to bear the risk.

little as a fiftieth of the declared capital paid in. The declared capital thus appears to be nearly as flexible as the "authorized capital" of a typical American corporation.

The minimum amounts of declared capital which are required by some of the European company statutes are not likely to deter investors who are prepared to cross the ocean to open a business; the highest are Germany's—about \$25,000 for a stock company, and \$5000 for a limited liability company.¹⁷⁶

2. SHARES OF STOCK; PAR VALUE

Some difficulty in talking about shares in European companies is occasioned by the fact that all the European countries have two terms, where we have only one. While we may speak indifferently of a man's "share" in a partnership, or his "share" in a corporation, the Europeans have one set of terms for a share in a partnership (*part*, *Teil*, *parte*, *deelbewijs*) and another set (*action*, *Aktie*, *azione*, *aandeel*) for a share in a stock company. This difference has to be noticed because in connection with the limited liability company Europeans always use the partnership term rather than the stock company term. Hence, the American investor will get a share called a *Teil* if he invests in a German limited liability company but will get a share called an *Aktie* if he invests in a German stock company.

This is the European jurists' way of emphasizing that the limited liability company share is non-negotiable, while the stock company share may be negotiable. For purposes of the incorporation process, the two kinds of shares are much alike. Both are normally stated in units of identical value, and the investor acquires a given number of such shares, as in an American corporation, rather than an undivided fraction of the equity, as in an American partnership. He buys 200 out of 1000 shares, not merely a "20% interest."

¹⁷⁶ Belgium: No minimum for a stock company; Bfr 50,000 (about \$1000) for SPRL, C. Com. I-IX, art. 120.

France: No minimum for stock company.

1,000,000 (old) Ffr (about \$2,000) for SARL, Law of 1925 art. 6.

Germany: 100,000 DM for stock company. AktG. § 7.

20,000 DM for GmbH. GmbHG § 5.

Italy: 1,000,000 IL (about \$1500) for a stock company. CODICE CIVILE art. 2327; reported due to be increased to 25,000,000 IL (about \$40,000). 50,000 IL (about \$75) for an SARL. CODICE CIVILE art. 2474; reported due to be increased to 1,500,000 IL (about \$2500).

Luxembourg: No minimum for stock company.

1,000,000 Lfr (about \$2000) for SARL. Company Law art. 182.

Netherlands: No minimum.

The shares are stated in money values, such as 500 francs or 100 marks,¹⁷⁷ except that Belgium and Luxembourg permit stock companies to issue shares without par value.¹⁷⁸ The other countries do not authorize no-par shares.

In Europe, as in America, shares cannot be issued for less than par,¹⁷⁹ but there is no law against issuing them above par, perhaps ten or twenty times above par.¹⁸⁰ Many European minimum par values are fairly low—for limited liability company shares about \$1.50 in Italy, and \$10 in France; for stock company shares only \$1.00 in Luxembourg.¹⁸¹ Hence it would be theoretically possible to introduce the "low-par" system in vogue in the United States. However, no one has done so, and we doubt that it would result (as in Delaware) in creating a large "surplus" which would be free of the restriction placed on capital.¹⁸²

3. PAYMENT FOR SHARES—MONEY OR PROPERTY

The Common Market countries have a curious collection of provisions regarding the payment of consideration for shares. They are rather different from any regulations known in the United States, but their origin is not hard to guess. It is evident that the free-booting promoters of the late nineteenth century, there as here, issued themselves shares for which they never paid at all, or for which they paid in property taken at gross over-valuations, with disastrous results for innocent investors and creditors.

¹⁷⁷ There are minimum share values in some countries:

France: 5000 Ffr (about \$10) for SARL, Law of 1925 art. 6.

Germany: 100 DM (about \$25) for AG, AktG § 8.

500 DM (about \$125) for GmbH, GmbHG § 35.

Italy: 1000 IL (about \$1.50) for SARL, CODICE CIVILE art. 2474.

Luxembourg: 50 Lfr (about \$1.00) for SA, Company Law art. 37. 500 Lfr (about \$10) for SARL, COMPANY LAW art. 182.

¹⁷⁸ Belgium: C. COM. I-IX, art. 41.

Luxembourg: Company Law art. 37.

¹⁷⁹ In the Netherlands, this is expressly provided, subject to the exception that the underwriter may receive a discount of 6%; W.K. art. 38a. In other countries, this rule is not expressly stated, as in many American corporation laws, but results from the requirement that the stated capital must be 100% subscribed. See note 163, *supra*.

¹⁸⁰ Liberty to sell for more than par is specifically granted in German stock companies. See AktG §9(2).

¹⁸¹ See note 177 *supra*.

¹⁸² German stock company law requires that any premium over par value be stated in the publicly filed documents of organization (AktG, §§ 16(2) and 28(2)), and that the premium should form part of a legal reserve which is not available for dividends (AktG § 130).

Italian law requires that premiums should not be disbursed until a reserve equal to one-fifth of the stated capital is accumulated from earnings (C. Civ. 2430), but apparently permits disbursement after that time.

To these evils American courts responded, as we know, with doctrines making subscribers liable for any deficiency in the value of consideration received for their shares.¹⁸³ Later, legislatures reacted with Blue Sky laws, designed to enable government officials to determine whether the initial investments in the company had been duly made.¹⁸⁴ European courts responded in different ways, and their responses explain some of the regulations on payment for shares. For cash payments there are regulations of special interest in French, German, and Italian stock companies, which concern the 25 or 30 percent of the stock subscriptions which must be paid in at or before the completion of incorporation. In France and Italy they must be deposited in a bank, or with a notary, where they are not available to the company and its promoters until the incorporation is complete in every respect.¹⁸⁵ Presumably these safeguards are designed to guarantee to creditors that the minimum capital has actually been paid in; or perhaps to guarantee to shareholders that their fellow shareholders have also made a proportionate contribution. In Germany they do not have to be banked, but if they are, the bank must certify that the deposits are unrestricted.¹⁸⁶

For the payment of subscriptions in property, the special regulations are more complicated and more widespread. In the first place, payments in property may have to be 100% paid in the course of incorporation; in France and Belgium the payments on account which are sometimes permissible for cash subscriptions are inadmissible for subscriptions payable in property.¹⁸⁷

Second, the property which is to be exchanged for stock must, in many instances, be stated in the articles, so that every other incorporator knows about it, and every creditor can learn about it. This is the rule in Belgium, Germany and Luxembourg both for stock companies and for limited liability companies.¹⁸⁸ It is the rule

¹⁸³ *Scovill v. Thayer*, 105 U.S. 143, 26 L. Ed. 968 (1881); STEVENS, HANDBOOK ON THE LAW OF PRIVATE CORPORATIONS § 183 (1949); BALLANTINE ON CORPORATIONS §§ 343 ff. (1947).

¹⁸⁴ LOSS and COWETT, BLUE SKY LAW 1-10 (1958); LOSS, SECURITIES REGULATION 7-16 (1951).

¹⁸⁵ France: Law of 1867, art. 1; the funds must be deposited in the official national depository—*Caisse des Dépôts et Consignations*—or with a notary.

Italy: CODICE CIVILE art. 2329; the payments must be made to a special account in any bank.

¹⁸⁶ AktG §§ 28(2), 29(1).

¹⁸⁷ See note 114. *Supra*.

¹⁸⁸ Belgium: C. Com. I-IX, art. 30 (stock company), art. 121 (limited liability company).

Germany: AktG § 20; GmbHG § 5(4).

for limited liability companies in France,¹⁸⁹ and for stock companies in the Netherlands.¹⁹⁰

A third regulation sometimes encountered is a requirement of appraisal, the most complicated plan for which is met in the French stock company.¹⁹¹ After the stock has been subscribed, a first meeting of subscribers is held, at which auditors are appointed. The meeting is adjourned, the auditors appraise the property, and a second subscribers' meeting is held to hear and to accept or reject the auditors' report. At this meeting, if the property transfer is approved, permanent officers may be elected, and the incorporation completed. In German stock companies, there is no second organization meeting, but independent auditors must be appointed to value the property, and the company must not do business until after the appraisal is made and reported to the court.¹⁹² In Italian companies of both types, a court-appointed auditor makes the appraisal which is attached to the incorporation papers; after the company is organized, the elected directors and auditors must review the appraisal.¹⁹³

A fourth precaution of the legislator is to impede transfer of the shares received for property. In French stock companies such shares cannot be represented by certificates, and hence are non-negotiable for two years after incorporation;¹⁹⁴ in Belgium and Luxembourg they are not freely negotiable for approximately two years;¹⁹⁵ in Italy they are non-transferable until the directors and auditors have made the post-incorporation appraisal.¹⁹⁶

A fifth hazard is reserved for the property-subscribers in a French limited liability company.¹⁹⁷ Instead of having an appraisal

Luxembourg: Company Law art. 27 (stock company), art. 184 (limited liability company).

¹⁸⁹ Law of 1925, art. 8.

¹⁹⁰ W.K. art. 40a. Netherlands, of course, has no limited liability companies.

¹⁹¹ Law of 1867, art. 4.

¹⁹² AktG §§ 25, 26, 34.

¹⁹³ CODICE CIVILE art. 2343 (stock companies), art. 2426 (limited liability companies). Deficiency in the value of the assets does not avoid the formation of the company, but merely requires a reduction in the stock allotted to the subscriber, and consequent reduction of the company's stated capital, unless the subscriber pays up the deficiency in money. The subscriber may elect to withdraw entirely, resulting in a still greater reduction in the stated capital.

¹⁹⁴ Law of 1867, art. 3(5).

¹⁹⁵ Belgium: C. COM. I-IX, art. 47. The shares can be transferred, but only if they are in registered form, and the transfer is made with specified formalities.

Luxembourg: Company Law art. 44.

¹⁹⁶ CODICE CIVILE art. 2343; the code declares the shares inalienable (inalienabili) during this period.

¹⁹⁷ Law of 1925, art. 8.

at the incorporation stage, the subscribers are made jointly liable to the company's creditors for any deficiency which may later appear to have existed between the value of the contributed property and the par value of the shares. Only when ten years have passed is this threat lifted.

These various regulations are not only burdensome; they are also rather fearsome beartraps, since any failure to comply may result in some sort of invalidity of the corporation, or liability of the incorporators, or both. The French legislator, in particular, seems to have prepared ambushes for any little businessman who might think of turning his business over to a corporation in exchange for a portion of the shares.

This situation calls for careful study by the American corporation which plans to establish subsidiaries in Europe. If the subsidiary has been preceded by any sort of operations in the area, the parent will be expecting to contribute money and property which was used in the pre-incorporation business. And if no thought were given to the matter, these assets would naturally be transferred in exchange for stock.

If the resulting formalities are found, on investigation, to be insufferable, there is sometimes a way of avoiding them. Imagine, for instance, an American corporation which was planning to transfer its stock of goods and intangibles, with its current bank account, to a forthcoming French subsidiary. Imagine further that the parent corporation planned to loan the subsidiary additional funds which might be useful in further development.

The parent can greatly simplify its problem by reversing the roles of property and cash. Instead of contributing property and loaning cash, it can contribute cash and loan property. That is, it may buy shares for cash, and transfer the property on a deferred payment plan. The financial risk is the same (assuming the amounts are equal), but the juridical risks which result from the special incorporation formalities are escaped. There may be some new formalities to be observed in regard to interested directors; but these are less burdensome.

In Germany this simple reversal of roles would not help much. There the special formalities which apply to exchanges of stock for property also apply to property purchases contemplated at the time of incorporation,¹⁹⁸ or made within two years thereafter.¹⁹⁹

¹⁹⁸ AktG § 20. See also § 45—purchases of property amounting to one-tenth of the corporate capital.

¹⁹⁹ AktG. § 45.

H. FILING AND APPROVAL

The procedures do not usually involve long waits for administrative action. In all the Common Market countries except the Netherlands, the ancient theory that incorporation is a privilege to be granted at the sovereign's discretion was discarded decades ago. For local citizens, incorporation is a matter of right; when the correct formalities have been executed, the papers deposited, there is nothing to wait for.

Even for foreigners, there are no administrative waits in connection with ordinary incorporations.²⁰⁰ Under international law they can lawfully be excluded from incorporation if they are not the beneficiaries of treaties of friendship, commerce, and navigation; but in fact they are not excluded. They do indeed encounter administrative obstacles in getting licenses to be merchants or corporate executives, or in getting licenses to exchange money for the purpose of investment, or in getting licenses to enter certain trades. But these obstacles are not connected with incorporation procedure.

In the Netherlands incorporation is not a matter of right, either for citizens or for foreigners. It is a privilege granted at the discretion of the Ministry of Justice. In considering whether to grant an application, the Ministry will consider all kinds of factors—whether the industry will further complicate an over-supply of goods or services, whether it will hurt or help the Netherlands' foreign exchange position, whether the proposed capital is adequate, and whether the financing plans offer any threat to the investment market. Presumably, a wise investor will explore all these matters before preparing incorporation papers. If major policy questions have been cleared in advance, less than a month will usually be required to obtain approval of the application to incorporate.

IV. MANAGEMENT OF A EUROPEAN SUBSIDIARY

The most elusive problem in all companies everywhere is probably management. If the right men can be given the right powers, they will solve the other problems. In foreign subsidiaries the problem is naturally complicated by different languages and different conceptions of teamwork, as well as by the special ambiguities of a subsidiary position.

²⁰⁰ The principal exceptions are (1) specially regulated types of enterprise, such as banks and insurance companies; (2) enterprises in which foreign participation is limited, such as (in France) petroleum extraction and newspaper publication.

In attacking these problems an American lawyer will need some conception of the legal structures of management in European countries, and some appreciation of how they differ from American legal structures.

A. THE PARALLEL ORGANS OF MANAGEMENT

The European corporate scene presents a surprising variety of organs of management. None of the organs corresponds exactly to American institutions, and the similarities in names are often more misleading than enlightening. Before we can discuss (in the English language) the European institutions, we will have to explain the European institutions which we are designating by our English terms.

I. SHAREHOLDERS

In Europe, as in the United States, we start logically with the holders of ultimate power—the shareholders. In Europe a sharp distinction is often drawn between holders of the normally *negotiable* shares of stock companies (who are called *actionnaires*, *Aktionäre*, *soci* or *aandelhouders*) and holders of the *non-negotiable* shares of limited liability companies and partnerships (who are called *associés*, *Gesellschafter*, *soci*, or *vennooten*). Since we have no such choice of terms in America, we will have to use the word “shareholders” to designate the holders of both types of European shares.

2. GOVERNING BOARD

After the “shareholders,” the most important title in the American corporate hierarchy is the “directors,”²⁰¹ and one is naturally tempted to search for the European institution which can be fairly translated by the same term.

The search is doomed to failure. The first problem is a linguistic one. The Europeans have corporate officials called by a name which looks like “director,”—*directeur*, *Direktor*, or *dirretore*—but they are in many ways the opposites of American directors. While the ordinary American “director” is almost always elected by the shareholders, the European *directeur*, *Direktor*, or *dirretore*, is never so elected. While the American title implies a deliberative, part-time

²⁰¹ Typical of the provisions indicated is the Delaware provision, “The business of every corporation . . . shall be managed by a board of directors, except as hereinafter or in its certificate of incorporation otherwise provided.” 8 DEL. CODE § 141 (1953).

position, the European title implies an executive, full-time position. While the American title implies a position on the highest hierarchical level (after the shareholders) the European title implies subjection to a superior board. Consequently, it is best to avoid entirely the word "director" in referring to European corporate officials.

When we turn from names to substance, the problem is still baffling. There are commonly not one, but two, boards which divide the functions of management and control. In the face of this duality, we can speak collectively of European boards only by making an arbitrary classification which achieves consistency on one plane at the price of inconsistency on another.

In the discussion which follows, we will adopt the name of "governing board" for that board which resembles the American board of directors in that (1) it is chosen by the shareholders and (2) it chooses other executives and managers to perform subordinate functions. This is the *conseil d'administration* in France and in French-speaking Belgium and Luxembourg, the *Aufsichtsrat* in Germany, the *consiglio d'amministrazione* in Italy, the *Verwaltung* in German-speaking Luxembourg, the *raad van bestuur* in Netherlands, and the *raad van beheer* in Flemish-speaking Belgium. The members of this board are variously known as *administrateurs*, *Aufsichtsratsmitglieder*, *amministratori*, *Verwalter*, *bestuurder*, and *beheerder*.

This board is not the only group chosen directly by the shareholders, for the same is true of the auditors (*commissaires aux comptes*, *Bilanzprüfer*, *sindaci*, *commisarissen*). Neither is it the only group which may name subordinate executives; in Germany, at least, this may be done by another board, the *Vorstand*. But it is the only group which is both chosen by the shareholders, and invested with authority to name managerial officers.

3. EXECUTIVES

Successful European companies, like their American counterparts, generally have a chief executive in whom all reins of authority are concentrated. We need not pause over a rare exception like the great Italian Montecatini Company, which concentrates executive power in two men of equal authority, like the ancient Roman consuls.

However, we must avoid assuming that the executive power is held by the presiding officer of the governing board, as it usually is in the United States. Although a European governing board usually elects a president, the presidency of that board signifies something

more like being an American "chairman of the board" than being an American "president." There are other titles which we will translate as "general manager" (*directeur général, direttore generale, algemeen bestuurder, algemeen beheerder*, and occasionally *General-direktor*) and "managing director" (*administrateur délégué*) which signify the concentration of executive power. Even in France, where the president is required by law to assume *responsibility* for the company's management, he has the choice of delegating the *authority* to a subordinate general manager, or exercising it himself under the compound title of "president and general manager" (*président-directeur-général*).

In Germany, the president of the "governing board" (that is, the board elected by the shareholders) is forbidden to be an executive; the executive power must be wielded by a subordinate board (the *Vorstand*), or *its* president (German stock companies having two boards and possibly two presidents).

There is also the possibility of having an executive officer elected directly by the shareholders, with no intervention of any board at all; this is possible in limited liability companies in all countries, and in stock companies of Belgium, Italy, and Luxembourg.

Hence we will speak of "executives" to designate those functionaries who hold the reins of authority under any of a great variety of titles, and by any of a great variety of methods of appointment.

4. AUDITORS

While American corporation laws leave directors free to choose the auditors of their books, European laws commonly provide formally for the election of officials to review the accounts and the performance of the management. The titles of most of these officials would be literally translated as "commissar"—*commissaire, Kommissar* (in Luxembourg), *commissaris*.²⁰² Since this word would probably evoke in most American readers visions of Stalinist agents, we will call these officials "auditors."

5. CONTROL

One other word which we cannot help using requires a little explanation. We will use "control" in the sense which has become fairly standard in America through Berle and Means' *Modern Corporation*²⁰³ and the rules of the Securities and Exchange Com-

²⁰² The German and Italian terms—*Bilanzprüfer* and *sindaci*—are less misleading.

²⁰³ BERLE and MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* especially at 69 ff. (1933).

mission;²⁰⁴ we use it to mean the ability to exercise a decisive influence on the management of the company—the relation which the U.S. government contended (and the companies denied) existed between General Motors and du Pont de Nemours.²⁰⁵

We mention this only because the cognate European words (*contrôle*, *Kontrolle*, *controllo*) are usually used in the more limited sense of the power to inspect accounts and review operations.²⁰⁶ This meaning is reflected in the American office of "controller," and is sometimes met in English-language discussions of foreign company law; it will not be used here.

For convenience of reference, on pages 92–93 we offer a table of English terms which we will use, and the indigenous names of the various institutions to which we will be referring.

B. MAJOR DIFFERENCES IN EUROPEAN MANAGEMENT STRUCTURE

The difficulty of naming the officials in European management reflects much deeper differences in their roles. We will sketch some of the more obvious differences, and show how an American investor may take advantage of these differences or, at least, minimize their inconveniences.

I. SUPREMACY OF THE SHAREHOLDERS

A striking peculiarity of European management structures is the power of the shareholders in the statutory plan. The legislator has not designed them to be a mere electoral college, to choose the leadership to which the company shall be entrusted. The shareholders are generally the supreme governing body, and the governing board is merely their agent, responsive to their will. Even in Germany, where the reforms of 1937 were intended to give increased independence to the executive board,²⁰⁷ the shareholders have distinctly greater powers than are usual in the United States. This conception expresses itself in many ways, such as the rule that dividends must be declared or at least confirmed by the shareholders²⁰⁸ rather than by the governing board alone, as in America.

²⁰⁴ See LOSS, SECURITIES REGULATION 453 ff. (1951).

²⁰⁵ Cf. Berle, Jr., *Control in Corporation Law*, 58 COLUM. L. REV. 1212 (1958); "Control may be defined as the ability to choose directors."

²⁰⁶ Cf. van Ryn who equates *contrôle* with "a mission to determine the necessary facts (about the management) and report the results to the shareholders." (This author's translation.) 1 PRINCIPES DE DROIT COMMERCIAL 416 (Belgium 1954).

²⁰⁷ HUECK, GESELLSCHAFTSRECHT, 125, 126 (Germany 1958).

²⁰⁸ Belgium: C. COM. I-IX, art. 79 (right to adopt financial statement in stock companies); art. 137 (same in limited liability companies). (Continued on p. 94)

<i>Country and Language</i>	<i>Shares</i>		<i>Shareholders</i>			<i>Governing Board</i>
	<i>(in stock company)</i>	<i>(in limited liability co.)</i>	<i>(in stock company)</i>	<i>(in limited liability co.)</i>	<i>Shareholders' Meeting</i>	
Belgium- French	actions	parts	actionnaires	associés	assemblée générale	conseil d'adminis- tration
Belgium- Flemish	aandelen	deelbewijzen	aandelhouders	vennooten	algemene ver- gadering	raad van beheer
France	actions	parts	actionnaires	associés	assemblée générale	conseil d'adminis- tration
Germany	Aktien	Anteile	Aktionäre	Gesellschafter	Hauptver- sammlung	Aufsichtsrat
Italy	azioni	quote	soci	soci	assemblea generale	consiglio di am- ministrazione
Luxembourg- French	actions	parts	actionnaires	associés	assemblée générale	conseil d'adminis- tration
Luxembourg- German	Aktien	Anteile	Aktionäre	Gesellschafter	Generalver- sammlung	Verwaltungsrat
Netherlands	aandelen	—	aandelhouders	—	algemene ver- gadering	raad van bestuur

<i>Country and Language</i>	<i>Member of Governing Board</i>	<i>General Manager</i>	<i>Departmental Manager</i>	<i>Manager (in limited liability co.)</i>	<i>Auditors</i>	<i>Board of Auditors</i>
Belgium- French	administrateur	directeur général	directeur	gérant	commissaires	collège de com- missaires
Belgium- Flemish	beheerder	algemen bestuurder	bestuurder	zaakvoerder	commissarissen	raad van com- misarissen
France	administrateur	directeur général	directeur	gérant	commissaires aux comptes (in stock co.)	conseil de sur- veillance (in lim. liab. co.)
Germany	Aufsichtsrat- mitglied	—	Direktor	Geschäfts- führer	Bilanzprüfer	—
Italy	amministratore	direttore generale	direttore	amministratore	sindaci	collegio sinda- cale
Luxembourg- French	administrateur	directeur général	directeur	gérant	commissaires aux comptes (in stock co.)	conseil de sur- veillance (in lim. liab. co.)
Luxembourg- German	Verwalter	General- direktor	Direktor	Geschäfts- führer	Kommissare	Aufsichtsrat
Netherlands	bestuurder	algemen bestuurder	bestuurder	—	commissarissen	raad van com- misarissen

The most important aspect of shareholder supremacy is the power to remove top management, which may be stated as a general principle of European company law, subject to some qualifications. Even in French limited liability companies, where the statute declares that the managers are never removable without cause during their terms,²⁰⁹ case law sanctions reservation in the articles of a power of removal. A qualification must be noted in Germany, where the shareholders' removal power affects the highest board (*Aufsichtsrat*) but not the subordinate executive board (*Vorstand*).²¹⁰ In some limited liability companies, managers who are named in the articles of incorporation are removable only for cause or as provided in the articles (or an amendment of them).²¹¹ Subject to these limited exceptions, European shareholders have the power to remove the board members without cause.²¹²

Another kind of qualification must be noted in Belgian and Luxembourg stock companies. Although the shareholders as a group are supreme, no one shareholder is allowed to vote more than two-fifths of the votes cast at any meeting, nor more than one-fifth of the outstanding shares.²¹³ An American parent company owning 99% of a Belgian subsidiary's stock might therefore find itself unable to oust a management, if the other 1% were held by the managers to be ousted. This eventuality should be foreseen and side-stepped by dividing the 99% between the parent and two other subsidiaries.

The shareholders' supremacy means a great deal to American

France: HAMEL, *TRAITÉ DE DROIT COMMERCIAL* no. 720 (1954); in limited liability companies, the manager may determine the dividends himself; *id.*, no. 812.

Germany: AktG § 126; GmbHG § 46(1).

Italy: CODICE CIVILE art. 2433 (stock companies); art. 2492 (limited liability companies).

Luxembourg: Company Law art. 75 (stock companies); *Cf.* art. 197, para. 5 (limited liability companies).

²⁰⁹ Law of 1925, art. 24, para. 3.

²¹⁰ AktG. §§ 75(3), 87(3). A commentator suggests that a shareholders' vote of no confidence in the executive board might be "cause" for removing them. GODIN-WILHELM, *AKTIENGESETZ* § 75, Anmerkung 7. But the decision would lie with the *Aufsichtsrat*.

²¹¹ Belgium: C. Com. I-IX, art. 129. Luxembourg: Company Law art. 191.

²¹² Belgium: C. Civ. I-IX, art. 53 (stock companies).

France: Law of 1867, art. 22 (stock companies).

Germany: AktG § 87(3); GmbHG § 38 (limited liability companies).

Italy: CODICE CIVILE art. 2383 (stock companies; removal subject to member's right to damages); art. 2487 (limited liability companies same as stock companies).

Netherlands: W.K. art. 48b.

²¹³ Luxembourg: Company Law art. 71(2).

Belgium: C. Com. I-IX, art. 76.

parents of European subsidiaries and offers an escape from a prevailing dilemma. On their first entry into Europe, American parent companies are faced with the alternative of staffing the subsidiary with Americans, who do not know much about Europe, or with Europeans whom the parent company does not know much about. The parents are understandably apprehensive of the possibility of runaway policies of European managers, because they do not know the Europeans' personal qualities so well, and they sense that their European employees are not so tightly tied as Americans would be to the parent company. In consequence, one finds many European governing boards in which a majority of seats has been reserved for Americans who can make only short and fleeting visits to Europe.

This reservation of a safe majority would be quite essential in an American corporation, where removal of directors is seldom provided for by statute and is generally presumed to be permissible only for cause. It is generally unnecessary in Europe, where the governing board of managers can be removed without any cause as quickly as a shareholders' meeting can be called. The hasty trans-Atlantic flights of American board members to make up a European company quorum are largely unnecessary. A single proxy-holder for a majority of the stock, living in Europe and keeping himself informed of the actions of the European board, could assure the board of immediate dismissal if they should disregard parent company wishes. This device is used successfully by at least one experienced American corporation in Europe.

Shareholder supremacy is also important to an American company which is buying control of a European company. When making a similar purchase of an American subsidiary, it would possibly bargain for resignations of the incumbent directors, so that it could make its newly acquired control effective. Such bargaining is unknown and unnecessary in most European companies because the power to dismiss the governing board or managers comes automatically with the ownership of shares.

2. ONE-MAN MANAGEMENT

A second major distinction of European management is the legality of one-man management, as opposed to the three-man board which comprises the usual minimum tolerated by American corporation statutes. Although one-man managements sometimes exist in U.S. practice, they exist only because no one bothers to en-

force the law requiring the election of additional directors, and their participation in management.

In Europe, on the other hand, one-man management is specifically authorized for limited liability companies in all countries,²¹⁴ and impliedly permitted even in the stock companies of Italy and the Netherlands.²¹⁵

The sole manager option was doubtless designed, at least in limited liability companies, to permit the incorporation of business enterprises which formerly had been sole proprietorships, and where the investors concurred in a desire to keep the same man at the helm. This may also be the reason why some laws facilitate the irremovability of the manager.²¹⁶

The convenience of one-man management for a company which is new in Europe is evident. An American investor may enter the European market with very slight acquaintance among European businessmen. If he does not have more than one American employee whom he wishes to keep in Europe, or no more than one European whom he trusts to run his business, he would have difficulty in naming a three-man board. Fortunately, he does not need three men. He can give all powers to the one man he trusts, until longer acquaintance enables him to broaden the managerial base with confidence.

The investor who takes this option must, of course, watch out for other risks. The one-man management may be irremovable except on proof of misconduct or incompetence unless proper reservations have been made in the articles of incorporation.^{217, 218} In addition to this, there are legal provisions which give the manager almost unlimited authority to bind the company.²¹⁹ Finally, there is the human danger that one head will make mistakes which three heads would have avoided.

²¹⁴ Belgium: C. Com. I-IX, art. 129.

France: Law of 1925, art. 24.

Germany: GmbHG § 6.

Italy: CODICE CIVILE art. 2487.

Luxembourg: Company Law art. 191.

²¹⁵ No number is specified by these stock company statutes:

Italy: CODICE CIVILE art. 2380.

Netherlands: W.K. art. 47a.

In one sense, one-man management is permitted by the German stock company law, since the executive board (*Vorstand*) may have only one member. But since there must be a three-man supervisory board (*Aufsichtsrat*) above him, this is not the kind of one-man management which simplifies a parent company's personnel problems.

²¹⁶ See notes 209, 210, 211 *supra*.

^{217, 218} See notes 209, 210, and 211 *supra*.

²¹⁹ In Belgium, France, and Luxembourg, the manager of a limited liability com-

3. ONE-COMPANY MANAGEMENT

Even more surprising from the American point of view is the rule which permits one company to occupy a position as manager, or governing board member, in another. Statutes forbid a company's filling certain positions, such as president of a French stock company,²²⁰ or any managerial office in a German company;²²¹ the interpretation of prevailing legal opinion is to a similar effect in Italy. European lawyers believe that managerial positions in the Benelux countries, and positions other than president in France can be filled by an artificial person as well as by a natural one.

Hence, the possibility arises of appointing another European company—perhaps an affiliated one—as sole manager of a European subsidiary. Of course, such an arrangement should be only temporary. As a matter of practical psychology, it is a good idea to have a board of living men with a lively interest in the company and sense of responsibility toward it. But the use of an incorporated manager may bridge difficult initial gaps. Since the corporate manager can appoint anyone it wishes to act as its human agent, the problem of managerial tenure is side-stepped.

4. GOVERNING BOARDS AND EXECUTIVES

We have already mentioned two peculiarities of European governing boards—the fact that in some kinds of companies there need not be a board and that, if there is one, its members can be removed at the unfettered will of the shareholders. A third peculiarity of European boards is that, with a few exceptions, the board members may act as a joint executive. They do not need to act through officers; they may, by virtue of their positions, act to negotiate and sign contracts. In short, most of the European laws make no provisions for the separation of policy-making and executive functions which are basic to American thinking about management structure.

In small enterprises this may be all to the good. Many American writers have been suggesting that we should in America provide for boardless management in "close corporations," and have cited Eu-

pany has unlimited power to bind the company unless limitations are contained in the duly published articles. Belgium: C. Com. I-IX, art. 130; France: Law of 1925, art. 24, para. 2; Luxembourg: Company Law art. 191. In Germany, the manager has full power to bind the company, and there is no means of limiting it. GmbHG § 37.

²²⁰ France: Law of March 4, 1943 (on stock companies) art. 12.

²²¹ AktG § 75(1)—executive board; § 86(2)—supervisory board. In the limited liability company, the prohibition of corporate managers is not express, but is inferred from various provisions. SCHOLZ, KOMMENTAR ZUM GmbHG § 6, Anmerkung III.

ropean experience to support their contention. But it is obvious that larger concerns need a plural board, with a systematic delegation of executive functions.

The significance of this state of affairs for the American investor is that in many European company forms he may and he must create the management structure that his business requires. The law does not furnish him a pattern into which he must fit. If he wants a one-man management, he can probably have it. If he wants a governing board, with a president, secretary, and treasurer, his lawyers will have to draw the articles of association so as to provide for them.

We will now deal with some of the exceptions to the general rule—exceptions which impose some standard pattern of organization on the European company. These mandatory patterns are found in the stock companies of Italy, France, and Germany.

The Italian law of stock companies requires the election of a president (*presidente*), but nothing is said about his powers or responsibilities;²²² the delegation of executive functions is therefore as unfettered as anywhere else. If the president is to have power to make contracts of purchase, sale, and employment, the articles of incorporation should say so. There are no requirements for a secretary or treasurer, and such officials are never used in purely Italian companies. American owned companies can and often do name such officials, but there is no great merit in the practice since the offices have no meaning for the Italians who deal with the company, and probably very little even for the Italians who fill the offices.

In France, the law has caught up with good business practice. It not only requires that each stock company have a three-member board, but also requires that the board elect a president, and that the president assume responsibility for the management of the company.²²³ Other board members must refrain from exercising executive functions unless they are appointed to them.²²⁴ The president may be the general manager or may appoint someone else to the job, but he is responsible for the management in either event.

The qualifications of board members and of the president are specific but not particularly onerous. The board members may not occupy similar positions in more than seven other French companies.²²⁵ The president cannot be simultaneously president of more

²²² C. Civ. art. 2380. The president may be elected by shareholders but if they fail to do so, he is chosen by his colleagues on the board.

²²³ Law of Nov. 16, 1940, art. 1-2; Law of March 4, 1943, art. 14.

²²⁴ *Ibid.*

²²⁵ Law of Nov. 16, 1940, art. 3, as amended by Law of July 7, 1953.

than two companies;²²⁶ but since the statutory office of president exists only in stock companies, this rule seems not to inhibit his serving as a manager of a limited liability company, or as a managing partner in a partnership. The president must be a natural person, but there is no rule against the other board members being companies.

These provisions of French law were adopted by the "collaborationist" government at Vichy, while northern France was occupied by Germany during World War II. They were precipitated by the disruption of management resulting from the division of the country by enemy occupation and the absence of board members who were either prisoners of war in Germany or with the outlawed Free French forces in Africa. The promulgation of these provisions as separate laws rather than amendments to the company law probably reflected the legislators' conception of them as emergency legislation, rather than permanent reform.

Probably no one wants a return to the amorphous pre-war law, but the present provisions are widely regarded as poorly designed. Dean Hamel of the Paris law faculty has written, with characteristic irony,

The law of 1940 gave companies a choice of two formulae,—that of the president-and-general-manager, or that of the nonexecutive president who is liable for the acts of his general manager. Several commentators thought they detected here a reflection of the German law of 1937, and of the famous *Führer-Prinzip*. The president was to be the head-man of the stock company. He does indeed occupy a fine position in the statutory text; but what a peculiar head-man—who can be removed at pleasure by his peers (the other board members), and even indirectly by the shareholders; whose powers depend on the authority which the board has given him, and can at any time amend. The president has only one characteristic of a head-man—increased liability. This feature is his best argument in deliberations, and it does increase his influence, if he knows how to use it.

What the law expresses is primarily the desire to put a stop to the parceling out of responsibilities between the president and the managing director, or worse, among several managing directors or general managers. It has concentrated responsibility on the president. That way, there is always someone to hold responsible.²²⁷

²²⁶ Law of Nov. 16, 1940, art. 3.

²²⁷ HAMEL, *op. cit. supra* note 208, no. 652 (1954).

5. THE GERMAN BOARDS

The organization of management in German stock companies is so distinctive that it calls for a special description. There are normally two boards,²²⁸ instead of one, which might be called "governing," and which divide between them the features and the functions of an American board of directors.

The one which we have grouped with other "governing boards" in the preceding discussion is more accurately called the "supervisory board" (*Aufsichtsrat*; literally, "board of oversight"). It resembles the American board of directors in that a majority of its members is elected by the shareholders,²²⁹ and in that it in turn elects the executives.²³⁰ It differs from an American board of directors in that its decisions do not bind the company in dealings with outsiders,²³¹ but it does make binding decisions to hire and fire executives²³² and set their pay;²³³ it elects the executives from persons who are not its own members;²³⁴ and its members include labor representatives, who must comprise one-third of the board's membership.²³⁵

The other German board we will call the "executive board," although its German name (*Vorstand*) apparently signifies something like "chairmanship" (literally, "those standing in front"). It resembles an American board of directors in that its decisions bind the company to outsiders,²³⁶ that its president, if any, is the chief executive of the company,²³⁷ and that each of its members is usually known as a *Direktor*.²³⁸ It differs from an American board of directors in that its members are not elected by the shareholders, but by the supervisory board;²³⁹ it is not necessarily a plural board, but may consist of only one man;²⁴⁰ if plural, it cannot elect its own

²²⁸ AktG §§ 70, 86.

²²⁹ *Id.* § 87(1).

²³⁰ *Id.* § 75(1).

²³¹ The statute provides that "conduct of business (*Massnahmen der Geschäftsführung*) cannot be taken over by the supervisory board." AktG § 95(5).

²³² AktG § 75.

²³³ *Id.* §§ 77, 97.

²³⁴ *Id.* § 90(1).

²³⁵ Betriebsverfassungsgesetz of Oct. 11, 1952 (hereinafter cited as BetrVerfG) (1952) 1 Bundesgesetzblatt 681.

²³⁶ AktG § 71.

²³⁷ At least, he holds the power of decision (AktG § 70(2)), although he does not automatically gain authority to deal with outsiders (§ 71(2)).

²³⁸ By prevailing practice, not law.

²³⁹ AktG § 75(1).

²⁴⁰ *Id.* § 70(2).

president but must await the supervisory board's decision as to whether there should be one and, if so, who he shall be;²⁴¹ if the board has a president, the other members cannot overrule him, but can be overruled by him;²⁴² its members are rarely outsiders, because they cannot be at the same time managing officers or general partners in any other commercial business.²⁴³

In the presence of these diversities, it seems futile to debate whether the American board of directors is more like the German supervisory board or the German executive board. The discussion would be like that of the blind men around the elephant. It would be further complicated by the fact that American boards are so disparate—some of them consisting largely of outsiders who review the executives' work, others consisting entirely of insiders, who carry on the work of the company under the guiding hand of the president.²⁴⁴ The former type of board is more like the German supervisory board; the latter type, more like the German executive board.

For an American enterprise which is first entering Germany, the staffing of the two boards presents problems. The supervisory board is a powerful group in which one would want to place only trusted and competent persons, but the persons must be "outsiders," holding no managerial office in the enterprise. Such persons are not easily found.

The choice of the executive board members also appears to be a very serious matter. Like most American directors, and unlike governing board members in some other countries, the German executive board members cannot be removed except for "good cause."²⁴⁵ The executive board's power to bind the corporation to outsiders cannot be limited by charter provisions.²⁴⁶

The problem of choosing members for the two German boards cannot be evaded by naming another company as a board member;

²⁴¹ *Id.* § 75(2).

²⁴² *Id.* § 70(2).

²⁴³ *Id.* § 79(1).

²⁴⁴ See BAKER, DIRECTORS AND THEIR FUNCTIONS, 11-27 (1945).

²⁴⁵ "Good cause" is not defined in the statute. Various commentators suggested soon after adoption of the statute that "good cause" might include such matters as a non-confidence vote by the shareholders, but the Federal Supreme Court has warned that such a vote would not be "good cause" if it were based on insubstantial grounds, or if it were adopted merely for the purpose of justifying the executive's dismissal. Decision of Apr. 28, 1954, Bundesgerichtshof (II Zivilsenat) 13 Entscheidungen des Bundesgerichtshofes in Zivilsachen (hereinafter cited as BGHZ) 188, at 193.

²⁴⁶ AktG. § 74(2). There is some dispute as to the effect of limitations on an outsider who has actual knowledge of them. HUECK, GESELLSCHAFTSVECKT 130 (1958).

the law specifically excludes this.²⁴⁷ The best one can do is to reduce the necessary number to one by incorporating in the limited liability company form, instead of the stock company. A limited liability company does not need to have a supervisory board unless it has 500 or more employees.²⁴⁸

Although the German two-board system is undeniably complex, it is not necessarily a system to be shunned. A distinguished Belgian writer compares it favorably with the Belgian system.²⁴⁹ German companies seem to have the reputation of being very well managed, and we think the system presents more advantages than obstacles to a company which is well-established, and which has ample resources of managerial man-power. But the system must be frankly regarded as burdensome for small, new companies, and probably contributes to the fact that limited liability companies are preferred to stock companies more frequently in Germany than in any other Common Market country.

6. LABOR PARTICIPATION IN MANAGEMENT; CO-DETERMINATION

In Europe as in the United States, the last decades have seen a phenomenal growth in the rights of labor representatives to influence the decisions of management. But the European developments have taken different forms from those which we have seen in North America.

One of the principal developments in Europe has been the labor-management councils, where representatives of labor and management meet together to discuss and resolve problems affecting both. These are not like American collective bargaining sessions, at which plenipotentiaries trade commitments binding each side to the other. They are more in the nature of forums at which representatives of each side try to persuade those of the other that it would be best for all parties if the other side's desires were met.

This institution has gone furthest in Germany, with its celebrated "co-determination." This term is coupled with another to make the title of Part IV of the German Plant Management Law of 1952²⁵⁰—Cooperation and Codetermination (*Mitwirkung* and *Mitbestimmung*). Every business establishment (subject to a few exemptions)

²⁴⁷ *Id.* § 75(1)—executive board § 86(2).

²⁴⁸ BetrVerfG § 77.

²⁴⁹ Van Ryn, *op. cit.* *supra* note 6, at 381, 382.

²⁵⁰ BetrVerfG, see note 48 *supra*.

has to have a plant council, elected by the employees.²⁵¹ They consult with the management on nearly every phase of operation. Their orbit includes specifically "group interests" (*soziale Angelegenheiten*) such as working hours, pay periods, and vacations,²⁵² and "individual interests" (*personelle Angelegenheiten*), such as hiring, firing, transfers, and promotions.²⁵³ Workers in larger enterprises also consult indirectly on "business matters," which embrace manufacturing methods, the production program, the financial status of the business, and market conditions.²⁵⁴ For these matters, there is an "economic committee" (*Wirtschaftsausschuss*) composed of at least four members named by management and four named by the plant council.²⁵⁵

The capstone of the German program is representation of labor in the supervisory board. One-third of the supervising board members are elected by the employees.²⁵⁶ That leaves two-thirds to be chosen by the shareholders; of these, one-third may be appointed by particular shareholders specified in the charter, while only one-third is required to be elected by the general body of shareholders.²⁵⁷ But usually the body of shareholders elects two-thirds.

The representation of employees in the supervisory board applies only to companies which have a supervisory board on which the employees can be represented. For this very purpose, the law of limited liability companies was amended in 1952 to require that they, too, should have supervisory boards, if their employees exceed 500.²⁵⁸ On the other hand, stock companies with fewer than 500 employees are exempted from the requirement if they are "family companies," owned entirely by one person or by a small group of closely related persons.²⁵⁹ Hence, employees have to be represented today on the boards of all non-family stock companies, and on the boards of limited liability companies which have more than 500 employees.

But exemption from board representation does not imply exemption from other phases of "co-operation and co-determination." ²⁶⁰

²⁵¹ BetrVerfG §§ 6-26.

²⁵² BetrVerfG § 56.

²⁵³ *Id.* § 60.

²⁵⁴ *Id.* § 67.

²⁵⁵ *Id.* § 68.

²⁵⁶ *Id.* § 76.

²⁵⁷ AktG § 88.

²⁵⁸ BetrVerfG § 77(1).

²⁵⁹ *Id.* § 76(6).

²⁶⁰ *Id.* §§ 49-75.

It is difficult to say whether the influence of employees in Germany is due chiefly to the plant councils alone (the *Betriebsräte*), or to the joint economic committees (*Wirtschaftsausschüssen*), or to representation on the supervisory board. Many companies which escape the requirement of labor representation on the supervisory board must still establish plant councils or joint economic committees or both.

France also has a law designed to enlarge the voice of labor in company management, dating from 1945, a few months after liberation.²⁶¹ This law provides for "enterprise committees" which consist of the chief officer of management and a delegation of worker representatives varying according to the number of employees to be represented. The enterprise committee is authorized to express its opinions on all questions which effect the organization of the business, or the distribution of profits; and has rights to be consulted on all matters affecting the management of the business, and its progress, and to receive the same financial statements which are given to shareholders. In stock companies, two labor representatives have the right to attend governing board meetings, with a right to speak but not to vote.²⁶²

According to our information, the voice of labor in German industry has been a good deal stronger than in France. We are told that French enterprise committees concern themselves chiefly with the pay and working conditions of the employees, while German employee representatives exercise a considerable influence on decisions affecting production.

In neither country do employee representatives dictate to company executives. Much less do they participate in the executive functions of management.²⁶³ The most that can be said is that in certain classes of German companies, employee representatives hold the balance of power in the election of executives when any substantial division arises among the shareholders' representatives.

In other Common Market countries, as in the United States, employee representation is less formalized, but employers are obliged by legal or extra-legal pressures to listen to their employee's desires and complaints. Luxembourg law provides for employee "delegations" to consult with management in the larger enterprises. In

²⁶¹ Ordinance of Feb. 22, 1945, instituting the "comités d'entreprises."

²⁶² *Id.* art. 3.

²⁶³ See AktG § 95(5), forbidding members of the governing board to take over conduct of the business (*Massnahmen der Geschäftsführung*).

Italy, "internal commissions" with consultative powers are commonly set up by collective bargaining agreements.

7. QUALIFICATIONS OF BOARD MEMBERS: NATIONALITY AND STOCKHOLDING

The laws of European countries are generally very liberal with respect to who may be members of the governing boards of companies. In two countries—France and Belgium—prior conviction of various heinous crimes will disqualify.²⁶⁴ In France, some or all of the board members must be French nationals in local railroad companies, hydroelectric companies, public utility companies, petroleum production companies, and companies formed for mining in French colonies.^{264a} In the Netherlands, a proportion of a shipping company governing board must be Dutchmen in order to permit the company to fly the Dutch flag.²⁶⁵ And in both French and Belgian companies, members of the governing board must obtain a "merchant's license." In France this is said to be obtainable by any foreign businessman who has no criminal or bankruptcy record; in Belgium it is said to be more exceptional. Aside from these requirements, European boards may legally be composed partly or wholly of Americans.

Only in French stock companies is it required that the board members be shareholders. In both French and Italian stock companies there are requirements that shares be deposited as security for the potential liability of the board members; in France these shares must be registered in the names of the members whose good conduct they secure.²⁶⁶ This probably means that the French board members should be beneficial shareholders; but in practice, "quali-

²⁶⁴ In France, there is a long list of offenses which disqualify for any office of management; the offenses include any common law felony, plus theft, embezzlement, violation of criminal provisions of bankruptcy law, including abortion or "contraceptive propaganda," and violating the laws on keeping of poisons. More accurately, it is not the offense but the prior conviction which disqualifies. A person may also be disqualified if he was a board member in an earlier company which entered bankruptcy, if the judge in that case made an order excluding him from managerial positions in the future. Decree-Law of Aug. 8, 1935, art. 6, 10; Law of August 30, 1947, art. 1-2.

There are somewhat similar provisions in Belgium; none have been cited to us from other countries.

^{264a} RIPERT, *TRAITÉ ÉLÉMENTAIRE DE DROIT COMMERCIAL* 545 (4th ed. 1959).

²⁶⁵ W.K. art. 311. If the necessary number of Dutch board members and managers is lacking, the company may still operate, but cannot fly the Dutch flag on its ships.

²⁶⁶ France: Law of 1867, art. 26 (stock companies).

Italy: CODICE CIVILE art. 2387 (stock companies). An Italian informant says that the shares may be endorsed and deposited by some other shareholder.

fyng shares" are transferred by the real owner into the name of the French board member. In Italy, shares are deposited for the non-owning board member without even putting them in his name.

The choice between foreign (American) or local (European) board members must be based less on legal than on practical considerations. We have encountered companies with the greatest variation in practice. One successful company with many foreign subsidiaries followed the practice of having the same three Americans serve as president, secretary, and treasurer, and also as directors, of more than a dozen foreign companies; they were also a majority of the board in most cases. At the other extreme, we have found subsidiary companies which take pride in having a board of exclusively "local" personnel. On examination of the facts, we sometimes found that some of the "all-French" boards were American citizens, but they were at least permanent residents of France.

Choices in these matters must depend on many factors, of which the foremost will be how many local people the investors know well enough to trust their integrity, ability, and judgment. But we wish to register the observation that the companies with the longest and most successful experience in foreign countries are those which tend most strongly to compose their boards exclusively of local residents, of whom a majority are local citizens.

This policy is not to be confused with that of permitting participation of local capital. Many of the companies which have gone the farthest in engaging local management are strictest in regard to holding substantially all the shares.

The reasons for employing local management are not based on apprehensions of hostility to Americans. So far as we can determine, neither banks nor regulatory agencies have any hostility to American managers. The main reason is that Europeans can do the job better. They are better guessers about the psychology of European buyers, sellers, laborers, and landlords. They are also better analysts of the objectives and the standards of European bankers who must lend money, and of the European officials who must grant permits and licenses. Their advantage in this respect cannot be bought from them in consultations as effectively as it can be evoked by giving them the responsibility for decision.

A second reason for employing local management is cost. We start from the fact that, in terms of official exchange rates, American salaries are higher for comparable jobs than are European. Europeans may live just as well or better on their nominally lower

salaries; but Americans going to Europe will demand the nominal equivalent of their American salaries, plus overseas benefits and travel expenses which will make their total cost about twice the cost of Europeans. A bull market for European managerial talent is reported to be narrowing the gap; but it will remain substantial.

Hence, we are inclined to believe that every investor in a European subsidiary should aim to reach the point where his entire governing board and executive personnel are European residents.

8. AUDITORS ²⁶⁷

The position of auditor in European companies is quite unlike anything known to the American corporation. Auditors in these countries are not mere outsiders hired by the board to report to it; they are officials of the company, elected by the shareholders to report on the managers. They are seldom optional; they are generally required by law.

Auditors are required for stock companies in Belgium, France, Germany, Luxembourg, and Italy; ²⁶⁸ in some of these countries they are also required for certain limited liability companies. ²⁶⁹ In the Netherlands, where auditors are not required by statute, they may be imposed by the company's own articles, and frequently are. ²⁷⁰

The various European legislatures have entrusted to their company auditors functions of varying scopes, but all of them are much broader than the functions of auditors in the United States. Stock company auditors in Belgium, France, Italy, and Luxembourg have

²⁶⁷ We use the term "auditor" for the following European company officials:

Belgium: "commissaires, commissarissen."

France: "commissaires" in stock companies; members of "conseils de surveillance" in limited liability companies.

Germany: "Jahresabschlussprüfer" in stock companies, "Bilanzprüfer" in limited liability companies.

Italy: "sindaci," or members of "collegio sindacale."

Luxembourg: "commissaires" or "Kommissäre" in stock companies; members of "conseil de surveillance" or "Aufsichtsrat" in limited liability companies.

Netherlands: "commissarissen."

²⁶⁸ Belgium: C. COM. I-IX, art. 64.

France: Law of 1867, art. 32.

Germany: AktG § 135(1).

Luxembourg: Company Law art. 61.

Italy: CODICE CIVILE art. 2397.

²⁶⁹ Belgium: C. COM. I-IX, art. 134 (over five shareholders).

France: Law of 1925, art. 32 (over twenty shareholders).

Italy: CODICE CIVILE art. 2488 (capital over one million lire—about \$1500).

Luxembourg: Company Law art. 200 (over twenty-five shareholders).

There is no corresponding requirement in Germany; but the limited liability company requires a governing board if its employees exceed 500.

²⁷⁰ W.K. art. 50.

authority to call shareholders' meetings,²⁷¹ and those in Luxembourg have "the unlimited power of supervision and inspection of all operations of the company."^{271a} The title of "supervisory board" (*conseil de surveillance, Aufsichtsrat*) borne by limited liability company auditors in France and Luxembourg suggests the breadth of their authority.²⁷² In Italy, the auditors are obliged to attend all shareholders' and governing board meetings,²⁷³ and to investigate shareholders' complaints against the management,²⁷⁴ and are liable along with board members for company losses which their due care should have prevented.²⁷⁵

In spite of these extended powers, the auditors are not in the line of command, as are the organs which we have called "governing boards." The decisive difference between them and the governing boards is their lack of power to choose the executives who run the company.²⁷⁶

Although auditors have been required in stock companies for many years, they have not always been very effective. Professor van Ryn of Brussels wrote of the Belgian situation before the legislation of 1953:

As for the auditors, the situation is still more peculiar (than for the governing board); nearly everyone agrees that they never, or hardly ever, effectively do the job of investigation (*contrôle*) which is their only excuse for existing. The job of auditor is generally a moderately lucrative sinecure, or a waiting room at the entrance of the governing board.²⁷⁷

²⁷¹ Belgium: C. COM. I-IX, art. 73.

France: Law of 1867, art. 32.

Italy: CODICE CIVILE art. 2367 (implication).

Luxembourg: Company Law art. 70.

The absence of a similar power in German auditors is probably explained by the grant of a similar power to the governing board (*Aufsichtsrat*), which is presumed to be as independent of management as the auditors.

^{271a} Company Law art. 62.

²⁷² France: Law of 1925, art. 32 (limited liability companies). Stock company auditors in France exercise a much narrower authority.

Luxembourg: Company Law art. 200 (limited liability companies).

²⁷³ C. CIV. art. 2405.

²⁷⁴ C. CIV. art. 2408.

²⁷⁵ C. CIV. art. 2407.

²⁷⁶ See A. A. Berle, "Control in Corporate Law, 58 COLUM. L. REV. 1212 (1958); "Control" may be defined as the capacity to choose directors. As a corollary, it carries capacity to influence the board of directors and possibly to dominate it.

²⁷⁷ VAN RYN, 1 PRINCIPES DE DROIT COMMERCIAL 382 (1953). See also VAN RYN, LA RÉFORME DU CONTRÔLE DES SOCIÉTÉS COMMERCIALES ET L'EXPÉRIENCE ANGLAISE (Belgium 1945).

Similar remarks could probably have been made in France before 1935.²⁷⁸

To eliminate subservience to the management, most of the countries now have laws designed to assure that the auditors will be completely independent. With some variations among countries, they are disqualified if they are employed by the company, or by the managers of the company, or by affiliated companies, and if they are related by blood or marriage to managers of the company which they audit.²⁷⁹

In Italy the law attempts to insure independence still further by giving the auditors tenure for at least a three-year term unless cause can be shown for their removal, and requiring that their pay be fixed in advance of their term.²⁸⁰ In other countries the auditors' tenure apparently remains subject to the will of the shareholders, even though they are elected for various terms ranging from three to six years.²⁸¹

There are also provisions in some countries requiring that the auditors be qualified accountants. Germany now requires that all auditors be certified public accountants.²⁸² In Belgium and France at least one of the auditors must be a certified public accountant in stock companies which have offered their shares to the general public.²⁸³ In Italian stock companies, at least one and sometimes two of the auditors must be certified.²⁸⁴ On the other hand, French limited

²⁷⁸ The Belgium company laws in the Commercial Code were amended in 1953 to tighten the auditing requirements. French laws had been revised in 1935 to assure independence of the auditors.

²⁷⁹ Belgium: C. Com. I-IX, art. 64, as amended in 1953.

France: Law of 1867, art. 33.

Germany: AktG § 137; there are no interdictions here on relationship by blood or marriage.

Italy: CODICE CIVILE 2399; auditors are also disqualified by a prior bankruptcy, or certain criminal offenses.

Luxembourg: Has no statutory disqualifications.

²⁸⁰ C. Civ. arts. 2400, 2402.

²⁸¹ Belgium: C. Com. I-IX, art. 64 bis (expressly removable at will of shareholders).

France: Law of 1867, art. 32 (provides 3 year term but is silent on tenure).

Germany: AktG. § 136(1) and (6).

Luxembourg: Company Law art. 61 (expressly removable at will).

²⁸³ AktG § 137 (*öffentlich bestellte Wirtschaftsprüfer oder Wirtschaftsprüfungsgesellschaften*).

²⁸⁴ France: Law of 1867, art. 33 (*dans les sociétés par actions faisant appel à l'épargne public*).

Belgium: C. Com. I-IX, art. 64 bis, 2 (*dans les sociétés ayant fait ou faisant appel à l'épargne public*).

²⁸⁴ CODICE CIVILE art. 2397; the requirement depends partly on the number of auditors (3 or 5) and partly on the capital (over or under 5 million lire).

liability company auditors are required to be shareholders, which makes it unlikely that they will be experts.²⁸⁵ Luxembourg and the Netherlands make no statutory requirements for either type of company.

To the American investor in a European subsidiary, the audit requirements will not seem very burdensome, but the naming of auditors for a term of years will call for some study, even though the appointment is revocable. A single auditor is all the law requires except for the requirement of shareholder-auditors in French limited liability companies, and a five-man requirement wherever auditors are needed in Italy.²⁸⁶ In Germany the appointee may be a qualified auditing firm, rather than an individual.²⁸⁷ Since the auditors' functions are supervisory rather than executive, qualified accountants can be safely named, even though they know nothing of the company's methods and objectives.

9. COMPENSATION OF BOARD MEMBERS AND EXECUTIVES

In Europe, as in the United States, a variety of systems of payment are in common use—fees for attendance at meetings, fixed salaries and profit shares. The only common form of American compensation which is never encountered in Europe is the stock option.

The stock option seems to hold no attractions for Europeans. Whether it would have any tax advantage, as it does in the United States, is dubious; at least there are no special provisions favoring it. There are many obstacles to its introduction. In the first place, many kinds of companies are forbidden to have authorized and unissued shares, or to hold treasury shares, against which the options could be allowed. Furthermore, most controlling stockholders in Europe are extremely jealous of their voting percentages, so that they would not be prone to issue new shares changing them. This jealousy is even more marked among American owners of stock in European subsidiaries, so that they would be much less willing to issue stock options in their European subsidiaries than they would in the parent companies. Mandatory preemptive rights, which give every shareholder a right to subscribe proportionately to new shares, would be an additional obstacle. The cumulation of obstacles to

²⁸⁵ Law of 1925, art. 32.

²⁸⁶ CODICE CIVILE art. 2397. The law says that the auditing board (*collegio sindacale*) may have either three or five members; but in either case, there must be two substitute members.

²⁸⁷ AktG § 137.

stock option compensation in Europe leads us to exclude it from further consideration.

In Europe, as in the United States, there are procedural problems in awarding compensation to governing board members, because of the conflict of interest involved in payments by the board to itself. As any American lawyer would expect, one way out is to submit the compensation arrangements to the shareholders for their approval, and this is expressly permitted by statutes in Italy and the Netherlands.²⁸⁸ But the American usage of inscribing the compensation plan in the by-laws cannot be used since there are no by-laws. Instead, we find many European compensation provisions in company charters.²⁸⁹

There is no necessity for shareholder action, or inclusion in the charter, where there is no conflict of interest. For instance, the German supervisory board can fix the compensation of the executive board. In France the governing board can fix the salaries of the president and of the general manager (whether the jobs are separate or combined), and can award compensation to other board members for specific services. Furthermore, when the shareholders have fixed the fraction of the profits which the board members may receive, the board members decide how to distribute it among themselves.²⁹⁰

A second problem is the percentage of the profits which can be awarded as compensation. In French stock companies this is limited to 10 percent.²⁹¹ In German stock companies, it is limited more generally to an amount which is "reasonably related to the expenditures made for the benefit of subordinate personnel, or for the common good." The public prosecutor is empowered to take action if this vague standard is violated, and the Minister of Justice may issue regulations to make it more specific. In both France and Germany the statutes require the setting aside of proper reserves before the profit shares are calculated.²⁹²

The deduction of profit shares in calculating taxable income is severely limited. In Italy they are never deductible. In France and

²⁸⁸ Italy: CODICE CIVILE art. 2389 (stock companies), 2487 (limited liability companies).

Netherlands: W.K. art. 48c.

²⁸⁹ This is expressly authorized by the Italian and Netherlands statutes cited in the preceding note, and in Germany, AktG § 98(1). The Italian law (C. Civ. 2389) permits the articles to authorize the governing board to fix the compensations of those members who have particular duties (*cariche particolari*)—a very vague phrase.

²⁹⁰ Law of March 4, 1943, art. 11.

²⁹¹ *Ibid.*

²⁹² See the immediately preceding citations.

Luxembourg a distinction is drawn between profit shares paid to the executive member of the board (*président* in France, *administrateur délégué* in Luxembourg), and to other members. The profit shares of the former are deductible; the other members' shares are not. As a consequence, profit shares are seldom awarded to non-executive board members; they are compensated in meeting fees, or salaries, which can be used to reduce the company's taxes.

There are other fine distinctions in the French taxation of executive compensation, which determine whether the compensation is taxed to the recipient at the basic rate of 5% or 22%. Only one of these is worth mentioning in relation to over-all planning. In the French limited liability company, a distinction is drawn between "majority managers," and "minority managers." The "majority managers" are those who hold a majority of the company stock, and their salaries are taxed at a higher basic rate, presumably on the suspicion that the salaries may be interchangeable with dividends. The tax can be escaped by turning the company into a stock company, where the same distinction is not applied. This difference has led to the common statement among French lawyers that the limited liability company is disadvantageous, from a tax point of view. This observation may be true for individual Frenchmen, but it will not be true for American parent corporations, which we presume will not wish to become the managers of French subsidiaries.

10. CIVIL LIABILITIES OF MANAGERS AND BOARD MEMBERS

The same duties which lie on American officers and directors to manage the business with reasonable care and skill fall on the shoulders of European managers and governing board members, and the same civil liability to indemnify the company or the unpaid creditors for the losses caused by these officials' sins of omission and commission.²⁹³

The law of France offers a very interesting addition to this burden. If a stock company becomes bankrupt, the trustee in the bankruptcy may petition the court to saddle the board members not

²⁹³ Belgium: C. Com. I-IX, art. 62 (stock companies), art. 132 (limited liability companies).

France: Law of 1867, art. 44 (stock companies); Law of 1925, art. 25 (limited liability companies).

Germany: AktG § 84 (executive board), § 99 (governing board); GmbHG § 43.

Italy: CODICE CIVILE, arts. 2392 (stock companies), 2487 (limited liability companies).

Luxembourg: Company Law art. 59 (stock companies), 192 (limited liability companies)

Netherlands: W.K. art. 47 c-d.

only with the losses traceable to their own conduct, but with all the debts of the company. Apparently, the trustee needs to present no evidence in support of his petition; the burden is on the president and the other board members to prove that they applied "the energy and the diligence of a full-time employee to the management of the company's business." ²⁹⁴

This unusual provision was another of the innovations of the Vichy régime. In an interesting case decided in 1951, the Court of Commerce for the Seine made each of the non-executive board members liable for 5% of the total company debts, and three persons who had served as president liable for 15%, 15%, and 35%, respectively. ²⁹⁵

Like some other Vichy embroideries on the fabric of company law, this one seems to be accepted as a permanent addition; the principle was extended in 1953 to French limited liability companies. ²⁹⁶ But it does not seem to have spread to other countries.

V. FINANCING A EUROPEAN SUBSIDIARY

A. MONETARY PROBLEMS

Every investment in European facilities will involve difficult choices between inside and outside sources of money. By "inside," we mean sources of money existing in the same country in which the facilities are to exist. "Outside" is more inclusive, because it may include (a) sources outside the country of investment but inside the Common Market, (b) sources which are outside the Market, but still inside Europe, or (c) sources outside the European continent. To be more concrete, a factory in France might be financed from the "inside" by French funds, or from the "outside" by funds from Belgium or Switzerland, or the United States.

I. THE LICENSING OF FOREIGN EXCHANGE TRANSACTIONS ²⁹⁷

As we write these lines, early in 1960, foreign exchange control laws are still in effect in all the Six Common Market countries. This

²⁹⁴ Law of Nov. 16, 1940, art. 4.

²⁹⁵ Decision of January 19, 1957, Tribunal de Commerce de la Seine (1951), 1 *Gazette de Palais* 239.

²⁹⁶ Law of 1925, art. 25, as amended by Decree-Law of August 9, 1953.

²⁹⁷ This subject is more fully explained in Chapter IV *supra*—"Foreign Exchange Controls in France," by M. Fernand Jeantet. See also Frank W. Swacker, *The Free Movement of Capital within the Common Market*, 15 *BUS. LAW.* 565 (1960).

means that a governmental agency—which we will call the “exchange control”—has power to forbid any foreign exchange transaction. If a French factory is to be built with money not now in France, the exchange control may by issuing an order (or refusing a license) forbid the purchase of French francs to build it. If the factory has been already built with foreign capital, the exchange control may by like means forbid the owner to turn his French profits into foreign currency in order to repay the foreign investor.

In practice, the Draconian powers of the exchange control are exercised in ways which are generally very favorable to foreign capitalists. In Belgium and Luxembourg, there is today a “general license” for all foreign capital investments; the foreign investor does not even have to get permission before investing, or before repatriating profits and capital. In France, which is currently the strictest of the Six in exchange control, a license is required both for original investment and for repatriation, but is now readily obtained. The license procedure survives chiefly in order to let the government assure itself that Frenchmen are not exporting their own capital (which they are still forbidden to do), and that capital movements are not made for illegal purposes (like supporting the Algerian rebellion).

The survival of the foreign exchange laws and (in some countries) of the licensing procedures also serves to remind the American investor that the present ease of investment and disinvestment is not necessarily a permanent feature of the European scene. Although the history of exchange control in Europe since 1945 is a story of progressive relaxation, there have been periods of renewed restriction as well as periods of relaxation; if future currency crises occur, they are likely to be accompanied by revivals of exchange restrictions.

Some protection against the effect of future restrictions may be obtained by obtaining from the exchange control agency a guarantee of the right to repatriate earnings and capital. In France, where a license to invest is still required, the control agency has an announced policy of permitting repatriation of licensed capital investments and of the profits produced by them. In Belgium and Luxembourg, where no license is required, the exchange control agency may on request give a special guarantee of future repatriation. In Italy, the control agency will guarantee repatriation of capital and unlimited earnings from investments which are deemed

particularly beneficial to the Italian economy, but only capital and earnings at 8% on other investments.²⁹⁸

In addition to the guarantee of repatriability which may be obtained from the exchange control agency, the investor may be interested in examining the guarantees which result from treaty obligations of the European powers. As a part of the plan to unify their economies, the Common Market countries have undertaken to "coordinate" their exchange controls with respect to the outside world, including the United States.²⁹⁹ This presumably means some increase in the strictness of controls in the countries which are now "wide open," and some relaxation in countries now strict. The objective is not an arithmetic average, as in the case of customs, but "the highest possible degree of liberalization."³⁰⁰ This presumably means the highest degree on which agreement can be obtained; and the agreement must be unanimous, before directives may issue.

Thus it appears likely, as Mr. Jeantet's essay reveals,³⁰¹ that differences between the strictness of the exchange controls which the various European countries apply to Americans and other outsiders may persist at least through the 1960's. Some will license investment and disinvestment very readily, and consistently. Others, with less stable currencies, may be more strict. To complicate the matter, the more strict countries will probably have waves of liberality, when they attempt to emulate the permissive habits of their neighbors, but will later retreat to longer or shorter periods in which repatriation of capital, or even of profits, is restricted.

These probabilities affect the financing plans of American enterprises in two ways. First, the prospect of a liberal foreign exchange policy in any given country increases the attractiveness of investing there; it decreases the risk that the investment will become temporarily or permanently unproductive of American dollars. Second, the prospect of restrictions on repatriation increases the importance of minimizing the investment of outside funds (*e.g.*, dollars) and of maximizing the use of inside funds (*e.g.*, French francs). Even though the parent company has no shortage of money to invest, it

²⁹⁸ Law No. 43 of Feb. 7, 1956, and Presidential Decree No. 758 of July 6, 1956. The investments which benefit from the unlimited guarantee are those called "productive," which are generally characterized by the purchase of tangible fixed assets. See *BANCO DI ROMA*, 1 *FOREIGN PRIVATE ENTERPRISE IN ITALY* 23-27 (2nd ed. 1959).

²⁹⁹ Treaty art. 70.

³⁰⁰ *Ibid.*

³⁰¹ *Supra*, note 297.

may wisely refrain from placing more than necessary in a country from which repatriation may prove difficult.

2. TREATY LIMITATIONS ON EXCHANGE CONTROLS

When and if currency controls are revived, inhibiting the repatriation from European countries of American capital and profits, Americans may notice that the controls are not erected against all equally; Americans may be unable to repatriate while residents of countries in the Organization for European Economic Cooperation (O.E.E.C.), and residents of Common Market countries, are less handicapped.

With respect to their fellow members in the O.E.E.C., each of the Common Market countries is somewhat limited in the extent to which it may restrict currency exchanges. The O.E.E.C. includes not only the six Common Market countries but also twelve others, including the "Outer Seven"; of these, England and Switzerland are of particular interest as possible bases of operation for American enterprise. At this writing, the United States is not a member.³⁰²

In 1953, the O.E.E.C. added to the Code of Liberalisation³⁰³ provisions by which the seventeen members bound themselves to each other to relax reciprocally their exchange restrictions on "invisible transactions," including, among other things, the following items:

Participation by subsidiary companies and branches in overhead expenses of parent companies situated abroad and vice versa . . .

Dividends and shares in profits.

Contractual amortization (with the exception of transfers in connection with amortization having the character either of anticipated repayments or of the discharge of accumulated arrears).³⁰⁴

With respect to all of these, the eighteen countries of the O.E.E.C. bind themselves to license transfers made pursuant to

³⁰² There are currently in process negotiations for a reorganization of the O.E.E.C. which would include the United States and Canada as full members.

³⁰³ The Code is strictly speaking a "decision" of the Council of the O.E.E.C., adopted in two official languages (English and French), and known in these languages as "Code de Libération" and "Code of Liberalisation." The original code, adopted in 1950, dealt only with quotas on goods.

³⁰⁴ These items are identified in Appendix B of the Code by references numbers Ch. I, B/7; Ch. II, B/1; Ch. III, B/2. They are only three out of several dozen kinds of "invisible transactions," so-called in contradistinction to "visible" international shipments of goods. Other invisible transactions include payment for ocean freight, repairs, liability for damages, travel, wages, royalties, etc.

prior licensed undertakings. If a Swiss investment in France was made in 1947 under an exchange license, France undertakes to license payments of the interest and dividends which may become due as a result of that licensed investment. However, the Code of Liberalisation enunciates no policies on the licensing of original investments which may give rise to future overhead expenses, dividends, interest or amortization. As to that, the member countries are presently free to choose. The Organization might conceivably broaden the Code to require freedom of investment among members; but this would require unanimous consent,³⁰⁵ and looks unlikely.³⁰⁶

Among Member Countries of the Common Market, currency controls are much further reduced. In the matter of "current payments" (on account of interest and dividends), all restrictions among member countries are to be lifted by the end of the first stage—that is, presumably by the end of 1961.³⁰⁷ Since current payments on licensed investments were already freed under the Code of Liberalisation, this provision promises an advance only in that it is not limited to current payments on investments which may have antedated the imposition of exchange controls.

What is more important, the Member Countries bind themselves to abolish by 1970, to the extent necessary for the proper functioning of the Common Market, "restrictions on the movement of capital belonging to persons resident in Member States."³⁰⁸ This means new investments. Legislative power to effect this end is given to the Council of the Community, which acquires the right to legislate by majority vote at the end of the second stage (December 1964).³⁰⁹ By 1970 money accumulated in a Belgian enterprise (for instance) can be invested in France to the extent that a majority of the Community Council thinks appropriate. To be sure, there are escape clauses permitting suspension of the liberties promised; but they are subject to decision of the Council of the Community.³¹⁰

³⁰⁵ See Elkin, *The Organization for European Economic Co-operation—its Structure and Powers*, 4 EUROPEAN YEARBOOK 96, at 115 (1958).

³⁰⁶ At present, the growth of the activities and powers of the O.E.E.C. seems to be arrested by the diversion of the leading powers' interest to the "Common Market" and the "Outer Seven."

³⁰⁷ Treaty art. 67(2).

³⁰⁸ Treaty art. 67(1).

³⁰⁹ Treaty art. 69. For the kind of "majority" required for this and other legislative acts, see Mr. Stein's study in this symposium.

³¹⁰ Under art. 73 (2) a state may on the ground of urgency take unilateral measures to arrest "disturbances in the capital market," but the Commission of the Community must be informed, and may modify or abolish the measures unilaterally taken.

As a matter of historic fact, the privilege of free investment by a national of one Member Country in another, which was promised for 1970, has already been granted in 1960. On May 11, 1960, the Community Council issued its Directive Number One on the subject of exchange control. It declared that nationals of one state were free to invest in another by purchase of operating properties (*investissements directs*), by purchase of securities which are traded on stock exchanges, and by purchase of new security offerings, and by various other financial means.

We will try to turn these principles into examples. An American company which wishes to form a French subsidiary must first get a permit to buy francs, and must later get further permits to turn its francs back into dollars to pay interest or repay capital. Currently, both permits may be readily obtained, but the permit to invest might become much harder to obtain on any slight change in the international financial climate; similar circumstances are likely to close down on permits to repay capital. Permits to pay interest and dividends to Americans are likely to survive until a severe crisis; but they enjoy no express treaty protection,³¹¹ and may be expected to be sacrificed before the permits to pay interest and dividends to other European countries—co-members of the O.E.E.C., or of the E.E.C., with whom France has treaty obligations to maintain freedom of exchange.

The position of a Swiss company is slightly better. As to permits to pay dividends and interest, it has the protection of the provisions of the Code of Liberalisation. As to permits to invest or withdraw capital, it is no better off than a Delaware corporation.

The position of a Belgian company is radically different. Procedurally, it has the advantage that there is an executive organ of the Community charged with issuing orders ("directives") to carry out the reciprocal liberalization to which the Member States are pledged.³¹² Substantively, it is guaranteed, after 1969, such freedom

³¹¹ Various Treaties of Commerce, Friendship and Navigation, or of Establishment, promise Americans equal rights with nationals, and rights equal to those of the most favored nation, in regard to exchange control. But since exchange control laws are generally *most* restrictive on nationals, and do not let them take out *any* profits except for special requirements, there is nothing to be desired about "national treatment."

The most-favored-nation clause will raise a more difficult question, when and if the Community Council exercises its powers to relay controls on capital movements between Member Countries. However, it is clear that European officials regard the Community as creating an exception to the most favored nation clause. Although American diplomats may argue to the contrary, we will consider this question on the basis of the law as it is now interpreted by the officials who apply and enforce it.

³¹² Treaty, art. 69.

to invest in France and in other countries of the market, and to withdraw its investments, as the Community Council decrees. That guarantee has already been put (revocably) into effect.

The marked advantages of a Belgian investor in the European market, and the lesser advantages of a Swiss investor, suggest the question whether a Belgian or Swiss company can qualify for the same advantages when it is American-owned. We have already noted that European law regards a company as a national of the country where it keeps its main office; hence one might fairly expect French exchange control officials to give O.E.E.C. treatment to all companies with home offices in Switzerland, regardless of who owns them. But there is one well-known exception to this view of nationality; in respect to seizure of "enemy property," French courts, like American, have recognized ultimate ownership of voting stock as the determinative criterion of nationality rather than location of the home office. That is, a German-owned Swiss company is German under the laws on enemy property.³¹³ French writers, describing this phenomenon, have referred to the home office test of nationality as the "private law test," and to the ultimate ownership test as the "public law test."³¹⁴ Since exchange control is undoubtedly a matter of "public law," the distinct possibility appears that American ownership would prevent a Swiss-based company from claiming the advantages of the Code of Liberalisation. This danger is particularly great in France, where the "control" test of corporate nationality attained great popularity, and was applied to deny foreign-owned companies any compensation for war damages, and even the protection of the new concept of "commercial property."³¹⁵

If we think of a Belgian subsidiary instead of a Swiss one, the effect of American ownership involves various provisions of the Treaty of Rome. In Article 58, the control test of company nationality is clearly rejected. It provides,

Companies constituted in accordance with the law of a Member State and having their registered office, central management or main establishment within the Community

³¹³ RABEL, 2 THE CONFLICT OF LAWS, A COMPARATIVE STUDY, 57 (1947). This view, which was rejected in the United States following World War I, (*Behn, Meyer & Co., v. Miller* 266 U.S. 457 (1925)), was adopted after World War II (*Clark v. Uebersee Finanz-Korporation* 332 U.S. 480 (1947)).

³¹⁴ ESCARRA, TRAITÉ THÉORIQUE ET PRATIQUE DE DROIT COMMERCIAL No. 63 (1950).

³¹⁵ Rabel *op. cit.* 59-62. The new U.S.-French Convention of Establishment guarantees Americans equal rights with Frenchmen in leasing real property; this may entitle Americans to "commercial property" in the future. Convention of Establishment between France and U.S.A., art. VII, 41 Dept. St. Bull. 828, 831 (1959).

shall, for the purposes of applying the provisions of this Chapter, be assimilated to natural persons being nationals of Member States.

But the article contains the tell-tale words, "for purposes of applying the provisions of this Chapter," and the article is found in Chapter 2, entitled "Right of Establishment." "Establishment" is defined as including "the right to engage in and carry on non-wage-earning activities, and also to set up and manage enterprises . . . subject to the provisions of the Chapter relating to capital."³¹⁶ The "movement of capital" is the subject of another Chapter.³¹⁷ Thus the Treaty clearly differentiates between "establishment" and "movement of capital."³¹⁸

We have spoken so far in terms of bona fide Belgian (or Dutch, or Luxembourgish, or German) companies, owned by Americans, which might wish to expand their operations, or reinvest their profits, in operations in another country (such as France or Italy). If such Belgian companies prove to be free from the exchange restrictions which confront direct American investments, some American would probably attempt to form a Belgian company which had no real Belgian activity, but was formed only to gain entry to France.

In response to any such scheme, France would have a clear right under the treaty to take preventive measures. The Treaty expressly provides that if residents of one Member State makes use of "transfer facilities within the Community . . . in order to evade the rules of one of the Member States in regard to third countries," the Member State may take appropriate counter measures.³¹⁹ It must consult the other Member States before acting, but does not

³¹⁶ Treaty art. 52 § 2.

³¹⁷ Chapter 4, entitled "Capital," comprises articles 67-73, of which the first provides that "Member States shall, in the course of the transitional period and to the extent necessary for the proper functioning of the Common Market, progressively abolish as between themselves restrictions on the movement of capital belonging to persons resident in Member States . . ."

³¹⁸ Chapter 2, Right of Establishment, and Chapter 4, Capital, are both parts of Title III, The Free Movement of Persons, Services, and Capital. But there are notable differences in the applicable provisions. Establishment is to be freed without qualification (art. 52) but capital movements are to be freed "to the extent necessary for the proper functioning of the Common Market" (art. 67(1)). On matters of establishment, the Council can act by majority vote after the end of the first stage (art. 54(2)), but on matters of capital movements only after the end of the second stage (art. 69).

However, M. Jeantet seems, in his discussion of "Probable Evolution under the E.E.C. Treaty," to believe that "investments" are entitled to the freedom promised by article 52 to "establishment." (See Chapter IV *supra*.)

³¹⁹ Treaty art. 70(2), par. 1.

need to get their agreement; the Community Council can later annul the action, but only on finding that it went "beyond what is required." ³²⁰

With respect to freedom of capital movement, the right which each Common Market country guarantees to the others is a right of "movement of capital belonging to persons in Member States" without "any discriminatory treatment based on nationality." ³²¹ The most obvious interpretation of this clause would be that Belgian companies would have freedom to invest in France (to the extent decreed by the Council) regardless of the ownership of their shares. It is not difficult to conjure up an opposing argument, to the effect that if the Belgian company belongs to Americans, its capital is *not* capital belonging to Belgians; but this argument is likely to be resisted by most of the Common Market members, and French officials might encounter some difficulty in determining just who owns the Belgian company anyway.

Our conclusion is that if France, for instance, should revert to a regime of severe exchange restrictions, companies situated in other Common Market countries (for instance, Belgium) would be much more favorably situated to effect currency exchanges than would Swiss-based or U.S.-based companies. The French might attempt special restrictions on Belgian companies which are owned by non-members of the Common Market; but their attempts to do so would confront practical problems in determining the facts of ownership, and legal problems as to their right to discriminate among Belgian companies based on their ownership. Some of the legal obstacles would be based on the Rome Treaty provisions which we have discussed above; others might be based on various treaties, especially treaties of friendship, commerce and navigation, which we have not mentioned.

Because of the complex of exchange regulations, and the possible effects of the Rome Treaty upon them, there appear to be important potential advantages in establishing an operating company in one of the Common Market countries, capitalizing it sufficiently so that it can engage in branch or subsidiary operations in other Common Market countries, and permitting earnings to accumulate to the extent that they may later be wanted for reinvestment in the other countries. It may prove a good deal easier to reinvest such earnings than earnings which have been remitted to the American parent

³²⁰ *Id.* art. 70(2), par. 2.

³²¹ *Id.* art. 67(1).

or to a Swiss holding company. There is the incidental advantage that such earnings will escape the corporate income which they might incur if remitted to the American parent.

3. FLUCTUATING EXCHANGE RATES

Assuming that permits to invest can be obtained, the investor confronts the problem of minimizing (or maximizing) the risk of currency fluctuation. If lire have been bought with dollars, and the lire decline in exchange value, obviously the same number of lire will not repurchase the same number of dollars. Conceivably, the lire decline will be accompanied by an increase in nominal lire profits, so that more lire will be earned, and the same number of dollars can be repurchased. But there is no certainty that this will happen.

Considerations of this order apply differently to equity and to debt investments. To a foreign subsidiary, a dollar debt will be a dangerous thing, if the subsidiary is in a country whose currency is likely to fall more than the dollar; in terms of the local currency, it is a debt that grows. A dollar equity is quite different; since no fixed obligation is incurred, it does not matter so much if the dollar dividends shrink.

Considering these factors, American parent companies will not ordinarily want their European subsidiaries to borrow dollars, nor will the parent companies want to *borrow* dollars, to invest in the subsidiaries. They will want to invest equity capital from America, and to borrow money, if at all, in the country where the business is to be operated. If the rates of interest in that country are too high to permit advantageous "trading on the equity," the correct conclusion will be to refrain from borrowing; it will not usually be wise to borrow money in another country (such as the United States or Switzerland) where interest rates may be lower, because such countries are likely to have currencies which will become dear in terms of the country where the interest must be earned.

One may be tempted to offset the potential loss from a foreign currency decline against the potential gain from a decline in American currency. An investor in Germany might contemplate the possibility that the German mark will be revalued against the dollar, and that his dollar debts will grow lighter, like a load of salt in a rainstorm. This is a dubious offset. In equity investments, the possibilities of loss may be offset against the possibilities of gain; but in fixed obligations, the possibility of loss is the possibility of disaster.

From these considerations, it follows that American investors will often be very much interested in the European market for loans, even though they are not interested in the European market for equity investment. This will probably be true even though all the European currencies now appear to be fairly stable; investment plans must contemplate the possible developments of future decades.

B. EQUITY FINANCING

I. DIVIDED OWNERSHIP

Most American companies, we have found, have little interest in sharing their equity interests in foreign subsidiaries with other persons. We think the reasons are generally well-founded, and will become progressively more apparent during the transitional period of the Common Market. Any company which has a French subsidiary and a German subsidiary, each making pins and needles, will find increasing occasion to concentrate the pin-making activity in one, and the needle-making activity in the other; or to close both and build a new plant in Luxembourg. Decisions of this sort which are very clear from the viewpoint of the parent company may be directly against the interest of any one of the subsidiaries. If so, these decisions will also be against the interest of the minority holders in the subsidiaries. The parent must then make the unpleasant choice between losing operating economies, and losing the confidence of a group of local investors. Foreseeing this problem, it will probably prefer to retain all the shares except the few that must be held by others in order to maintain the minimum number of shareholders required by European company laws.

There are very few legal impediments to 99% ownership of a European affiliated company. Our French collaborator advises that France has laws requiring majority or complete ownership by nationals in French companies which operate a travel agency, an accounting business, or a bank, or which claim compensation for war damage.³²² There may be other categories, but they are exceptional rather than typical.

The effect of these restrictions on Americans will be limited by the new U.S.-French Convention on Establishment, which permits exclusion of American interests only in "communications, air or water transport, banking . . . , exploitation of the soil or other

³²² But cf. Ripert, *op. cit.*, 454, stating that the law regarding travel agencies is the only one which makes an issue of the source of capital.

natural resources, and the production of electricity.”³²³ This treaty will forbid any direct prohibition on ownership, although it will not necessarily prevent the French from refusing to license currency exchanges for the purpose of buying interests in particular kinds of business.³²⁴

A more important undermining of these restrictions arises from the Treaty. Under Article 221, each Common Market Country must permit investment by nationals of other countries to the same extent as investment by its own nationals. Under this clause, an American-owned Dutch subsidiary may own stock in a French company, even though the American company is forbidden to own directly. The sweeping terms of the directive of May 11, 1960,³²⁵ indicate that exchange control will not be used as a means of blocking Dutch company investment in France.

Consequently, a 99% ownership of a European subsidiary seems to be legally attainable. However, there may be practical difficulties. If the American investor finds the right enterprise, its owners are not likely to be eager to sell out. If the American investor attempts to build a new enterprise, he must find a site, build a plant, buy equipment, hire labor and executives, and organize a distribution system, in a country where sites are generally more scarce, labor less mobile, trained executives less numerous, and distribution systems more tied up than in the United States—and in a country where he has to speak through interpreters.

American investors frequently decide that the perils of building a new enterprise are less than those of divided ownership. If they are able to find a European going concern which has plant and personnel and outlets, and which is willing to sell a substantial

³²³ Convention of Establishment between France and the United States, Nov. 25, 1959, art. V(2), 51 Dept. State Bull. 829.

³²⁴ Even if 99% ownership is permitted by law, it may be a factor which makes exchange control officials reluctant to grant investment licenses, as M. Jeantet suggests in his essay on exchange control. We have no similar reports from other countries of the Market. With respect to joint investment, a distinction may generally be drawn between European countries, which are themselves exporters of capital, and the “under-developed countries” of other continents, where there is a heightened sensitivity to foreign domination of ownership. The reasons which may dictate joint investment in those countries do not apply significantly to the member states of the European Economic Community. We have been privileged to see pre-publication manuscripts of an extraordinary series of studies directed by Professor Wolfgang Friedman of Columbia University on Joint International Business Ventures, which concerns joint investment in various countries by the United States and local interests. Among the countries discussed as investment locations are Burma, Cuba, India, Pakistan, Philippine Islands, and Turkey. There is a volume on Japan, but it concerns foreign investment by Japan in other countries.

³²⁵ European Economic Community, First Directive under Article 67, May 11, 1960.

portion, but not all, of its shares, many American investors will quite properly be attracted by this alternative. In the course of time, they will probably be trying to buy out the local interests, but this does not prove they did not make the best choice in joining with local interests rather than starting from scratch.

Which choice is to be preferred obviously depends on the characteristics of the particular choices that are available. We think it is safe to say that the building of a foreign business from scratch is for those American investors who have extensive prior foreign experience, who already have significant commercial contracts in the country where the enterprise is to be created, and which need facilities that are considerably different from any already available in the country in question. Investors without these advantages should generally seek to acquire existing enterprises, and settle for divided ownership if they cannot obtain 99%.

2. CONTROL DEVICES

In many cases, the American investor will want to know whether he can reserve voting powers which are proportionately greater than his equity investment. The first answer is that one cannot do it by any method so simple as the issue of non-voting common stock. The general rule in all six countries is that all shares vote.³²⁶ There are statutory exceptions in two countries—Germany and Italy—for preferred stock;³²⁷ but preferred stock is no more fashionable in today's German and Italian capital markets than it is in America. Another familiar American device that is not likely to work in Europe is to have two classes of shares—one worth a dollar, and the other worth a hundred dollars—which have equal votes per share. Italy and Luxembourg require that all shares in stock companies have equal value.³²⁸ Belgian, French and Dutch laws expressly provide that shares shall vote in proportion to the capital which they

³²⁶ Belgium: C. Com. I, IX, art. 74, as amended by Arrêté Royal No. 26 of Oct. 31, 1934, art. 3 (stock companies); C. Com. I, IX, art. 135 (limited liability companies).

France: Law of Nov. 13, 1933, art. 1 (stock companies); Law of March 7, 1925, art. 28.

Germany: AktG § 114(1); GmbHG § 47.

Italy: C. Civ. 2351 (stock companies), 2485 (limited liability companies).

Luxembourg: Company Law arts. 71(2) (stock companies), 195 (limited liability companies).

Netherlands: C. Com. art. 44b.

³²⁷ Germany: AktG § 115(1); the shares must be cumulative without limit; and cannot exceed half of the voting shares.

Italy: C. Civ. art. 2351; the non-voting shares must not be more than half of all shares.

³²⁸ Italy: C. Civ. art. 2348.

Luxembourg: Company Law art. 37.

represent;³²⁹ in other countries which have no similar statutes, this stratagem would probably be regarded as a violation of the general rule that all shares vote.

So far as European laws permit departure from the principle of voting in proportion to investment, the departure tends to dissipate control, rather than to concentrate it. Belgium furnishes an extreme example, with her law that a majority owner can never cast a majority of votes; a single voter cannot vote more than one-fifth of the shares outstanding, nor cast more than two-fifths of the votes cast at any meeting.³³⁰ This is a rule of public policy, not alterable by the charter. Owning fifty-one percent of the stock is therefore no guarantee of control, unless the fifty-one percent is distributed among three different shareholders, who vote in harmony. Happily, this provision is not mandatory in other countries; the German law mentions it, but only as a permissible clause in the charter.³³¹

At the same time, France and Belgium offer a very interesting institution for recognizing investment without a grant of proportionate voting power. American lawyers will recall the problems which arose in the days of high-par stock with regard to mines or patents or good will exchanged for stock; if later events showed the property to be worth less than the par value of the stock, the contributors were in danger of liability.³³² This problem was solved in France and Belgium by invention of "founders' " and "beneficial" shares;³³³ they are also known in Italy.³³⁴ These do not purport to be contributions to capital, and do not share in capital distribution on liquidation; hence the specific value of the property contributed becomes immaterial. But these shares do receive dividends, just like other shares.

We have mentioned them at this point, because they do not neces-

³²⁹ Belgium: C. Com. I, IX, art. 74, as amended by Law of Nov. 10, 1953, art. 1, § 4.

France: Law of Nov. 13, 1933, art. 1.

Netherlands: C. Com. art. 44b.

³³⁰ C. Com. I, IX, art. 76.

³³¹ AktG art. 114(1). See also Neth. C. Com. art. 44b.

³³² BALLANTINE ON CORPORATIONS, 789 (Rev. ed. 1946); LATTIN, THE LAW OF CORPORATIONS, 399 ff. (1959); STEVENS, HANDBOOK OF THE LAW OF PRIVATE CORPORATIONS, 842 ff. (2nd ed. 1949).

³³³ See HAMEL, TRAITÉ DE DROIT COMMERCIAL No. 566-68 (1954).

For statutory recognition of these types of shares, see:

Belgium: C. Com. I, IX, art. 75.

France: Law of Jan. 23, 1929, art. 1.

Law of Nov. 13, 1933, art. 1.

³³⁴ Beneficial shares (*azioni di godimento*) are mentioned by the statute only in connection with reductions of capital (C. Civ. 2353), but are believed to be usable in a variety of other circumstances,

sarily have voting rights. In Belgium, they may be given votes, but the total votes ascribed to such shares must not exceed half the votes ascribed to regular ("capital") shares; in counting votes, theirs must not be counted for more than two-thirds of the total counted for regular shares.³³⁵

These special shares can be used in various ways to adjust voting power in a jointly-owned enterprise. If voting power is to be divided in a different ratio from profits, most of the shares (*e.g.*, 9990) may be "beneficial shares," in the ratio desired for profit division, with a very small number of ordinary shares (*e.g.*, 10) divided in the ratio desired for control.

There remain two more vote-shifting devices in French law which hold some interest for an American investor. One is the permission to create shares which have a double vote, when they have been held in registered (not bearer) form for two years.³³⁶ Although this device was probably originated as a means of keeping American speculators from gaining control of French enterprises at times of currency devaluation,³³⁷ and the charter may exclude foreigners from acquiring the double vote,³³⁸ there is nothing now to prevent its being used to protect an American plurality. Another device is to exclude from attendance at meetings holders of less than a given number of shares, which may be set as high as 20, or one-twenty-thousandth (.0005) of the total capital (whichever is higher).³³⁹ We mention these without any recommendation as to when they might be used, because we suspect that under most circumstances they would do more harm than good.

Various other devices employed in the United States to stabilize management in the presence of divided ownership are unavailable in the Community countries, and the voting trust (like other varieties of trust) is unknown, except in the Netherlands.

Voting agreements between different groups of security holders are evidently in use, but their enforceability is dubious at best. In France, any agreement which limits the voting freedom of a stock company shareholder is declared to be invalid.³⁴⁰ However, the law is not thought to forbid caucuses in which groups of shareholders agree as to how they will vote, without actually binding themselves;

³³⁵ C. COM. I, IX, art. 75.

³³⁶ Law of Nov. 13, 1933, art. 1.

³³⁷ See HAMEL, *TRAITÉ DE DROIT COMMERCIAL* No. 547 (1954).

³³⁸ Law of Nov. 13, 1933, art. 1.

³³⁹ *Ibid.*

³⁴⁰ Law of Nov. 13, 1933, art. 4, as amended by Decree-Law August 31, 1937.

nor does it apply to agreements among governing board members. The law does not purport to apply to limited liability companies; voting agreements as to them are presumably valid, and may be further cemented by the previously mentioned restrictions on share transfers,³⁴¹ and appointment of a manager for an indefinite or a long term who cannot be removed without cause.³⁴²

In Germany, there is no law against voting agreements, but there is a criminal law against giving a consideration for a stock company shareholder's vote.³⁴³ Presumably this does not forbid an exchange of voting promises among shareholders, but penalizes the taking of some extraneous monetary consideration.

In Belgium, a leading commentator believes that all voting agreements are invalid.³⁴⁴ An earlier Italian view to the same effect has recently given way to the view that agreements among shareholders as to how they will vote their own stock are legal; but they will not be specifically enforced, and a shareholder cannot separate himself from the voting power.

Possibilities of proxy control may also be considered. In France and Germany it appears that proxies can never be irrevocable;³⁴⁵ a Belgian commentator believes they can be irrevocable there, within reasonable limits.³⁴⁶ There are no such rules about proxy solicitation as we have in the United States under section 14 of the Securities Exchange Act, but the Netherlands forbid solicitation by members of the governing board.³⁴⁷ In other countries, management solicitation of proxies is apparently untrammelled, and "proxy control" exists in many large European companies. But this would seem to be of little interest to American investors in subsidiaries or affiliates, since the shareholders are unlikely to be so dispersed as to make proxy control effective.

Only in the Netherlands do we find clear judicial approval of voting agreements among public shareholders,³⁴⁸ and common usage of a well-recognized medium for company control by agreement of the investors—the voting trust. This operates much like an Ameri-

³⁴¹ Law of March 7, 1925, art. 22.

³⁴² *Id.* art. 24.

³⁴³ AktG § 299.

³⁴⁴ VAN RYN, 1 PRIN. DE DROIT COMMERCIAL No. 707 (1954).

³⁴⁵ France: HAMEL, *op. cit. supra* note 337, No. 533.

Germany: AktG § 114(4).

³⁴⁶ VAN RYN, *op. cit. supra* note 344, No. 689.

³⁴⁷ W.K. art. 44a.

³⁴⁸ Hooge Raad, June 30, 1944, *Nederlandsche Jurisprudentie* 1944, No. 465.

can voting trust. It is of considerable interest to American participants in a "joint investment" with Dutch investors; they might agree on a board of voting trustees which contained representatives of each investing group, plus some neutral party chosen from a Dutch bank (for instance), or even from another country.

3. KINDS OF SHARES: DEGREES OF NEGOTIABILITY

In the matter of shares, European companies have a variety of forms which have no parallel in America. Our kind of shares—registered in the name of the owner, but negotiable by indorsement and delivery—does not exist in Europe. Instead, they have three other kinds of shares, one of which is found in limited liability companies, and the other two in stock companies.

For simplicity, we will start with the limited liability company share (called *part*, *Anteil*, *parte*, and *deelbewijs*, in the various languages). It is more like a share in an American partnership than like a share in an American corporation. It is never negotiable, never eligible for public issue, never listed on stock exchanges, and frequently transferable only with consent of the company or the other shareholders.³⁴⁹ It resembles a share in an American corporation only in that it is a unit of stated value, identical with others in the same company.

In stock companies, the share is so differently conceived by Europeans that they give it a different name from the limited liability company share. It is an *action*, *Aktie*, *azione*, or *aandeel*, and it is so distinctive that in Germany and Italy this kind of company is named for the kind of shares it issues—*Aktiengesellschaft* or *società per azioni*. The outstanding feature about the stock company share is the fact that it can be put in a negotiable form, which can be transferred endlessly from owner to owner

³⁴⁹ Not all these negative characteristics are explicitly stated in the limited liability statutes; more often they are implied from the fact that the statute used the word which applies to partnership shares, rather than the word which applies to stock company shares, and fails to authorize negotiable features. See the following:

Belgium: C. Com. I, IX, art. 124-25 (shares not transferable even between parties without entry on company books).

France: Law of March 7, 1925, art. 22-23 (shares not transferable without consent of fellow-shareholders; transfer ineffective for any purpose until registered).

Germany: GmbHG § 15 (share transfers must be notarized).

Italy: C. Civ. art. 2479 (no special provisions, but no such authorization for bearer certificates as is made for stock companies).

Luxembourg: Company Law, art. 189 (no transfer without consent of other shareholders).

with no registration, just like money; this form is the "bearer share" (*action au porteur, Inhaberaktie, azione al portatore, aandeel aan tonder*).³⁵⁰

The bearer share is the typical share in publicly held European stock companies, with many interesting consequences. One of these is that when war breaks out, shareholders who are nationals of an enemy country, but whose identity is unknown, may be able to sell their holdings in Switzerland, rather than having them seized as enemy property at the home of the company. Another consequence is that the principal holders of shares in large companies may readily remain unknown, so that questions of "control" which have become prominent in proceedings of the American Securities Exchange Commission, Interstate Commerce Commission, or Anti-Trust Division can hardly be even discussed in Europe. Likewise, there is unlikely to be any knowledge of the "insider trading" which has given rise in this country to statutory liabilities under Securities Exchange Act section 16(b) or Securities Exchange Commission Rule X-10-b-5.

The absence of a record of ownership has necessarily led to other practices which are unknown in the United States. Share certificates have attached to them coupons which are deposited in banks for collection of dividends, like American interest coupons, even though the amount of the dividend varies each year, or may be nothing. The company has no idea as to who is the recipient of the dividend, and cannot report him to the income tax collector. In order to establish the right to vote, certificates may be deposited with a bank, which certifies as to the number deposited, and generally exercises the owner's proxy.³⁵¹ If the owner does not give directions, the banker exercises his own judgment. In this way, shareholder apathy in Europe gives great power to bankers instead of, as in the United States, to company management.

The other kind of share in a stock company we will call by the familiar American name of "registered share," although some writers prefer to call it "nominative share" (*action nominative*,

³⁵⁰ Belgium: C. Com. I, IX, art. 45.

France: C. Com. art. 35.

Germany: AktG § 10.

Italy: C. Civ. art. 2355.

Luxembourg: Company Law art. 37.

Netherlands: W.K. art. 38c, 38d.

³⁵¹ The proxy-holder must disclose that he votes as agent, in Belgium and Luxembourg. It is forbidden to vote "as owner" shares belonging to another. Belg. C. Com. I, IX, art. 200; Lux. Company Law art. 162.

Namensaktie, azione nominativa, aandeel op naam). Although bearer shares are generally preferred by European investors, registered shares play a considerable role.

In Italy, there are currently no bearer shares. Measures of economic warfare, adopted almost twenty years ago, required that all shares be put in registered form.³⁵² These have been kept in effect, presumably for the aid which they give to enforcement of taxes, exchange control, and other legislation.

In other countries, too, shares are sometimes required to be registered for financial reasons. Everywhere, shares must be registered until their full value has been paid in to the company.³⁵³ Under the codes of French inspiration, shares which are issued in exchange for property are required to be registered for a "cooling off period,"³⁵⁴ or else (in Luxembourg) deposited in the company treasury.³⁵⁵ The objective is to delay speculative trading until the securities are adequately "seasoned." Where governing board members are required to be shareholders, the required shares must be registered in their names.³⁵⁶

How great a disadvantage it is to have a share in registered, instead of bearer form, we have not been able to tell. It seems clear that outside of Italy, shares must be in bearer form in order to be acceptable to buyers on organized security markets. But in Italy, share trading seems to have revived on and off the exchanges without the aid of bearer shares. Since the registered share has not long been an article of commerce, we suspect that the European law is

³⁵² Decree-Laws of Oct. 25, 1941, No. 1148; March 29, 1942, No. 239.

³⁵³ Belgium: C. Com. I, IX, art. 46.

France: Law of 1867, art. 3, as amended by Decree of Dec. 7, 1954 (all shares registered until fully paid for).

Germany: AktG § 10(2).

Italy: C. Civ. art. 2355.

Luxembourg: Company Law, art. 43.

Netherlands: W.K. art. 38c.

³⁵⁴ Belgium: C. Com. I, IX, art. 47 (until ten days after the company's second annual report is published).

France: Law of 1867, art. 3, as amended by Decree of Dec. 7, 1954 (shares "not negotiable" and certificates not to be issued until two years after incorporation).

Italy: Cf. C. Civ. art. 2343 (shares issued for property not transferable at all until property is appraised by an expert, and appraisal reviewed by board members and auditors).

Luxembourg: Company Law art. 44 (shares not negotiable until 10 days after the second annual report of the company is published) 47.

³⁵⁵ Company Law art. 47 § 2.

³⁵⁶ Belgium: C. Com. I, IX, art. 57.

France: Law of 1867, art. 26 (further, certificates must be deposited in company treasury, and stamped to show that they are not transferable).

Luxembourg: Company Law art. 54.

much like that of the United States before adoption of the Uniform Stock Transfer Act; that is, somewhat unsettled, but not wholly incompatible with reasonable stock trading.

4. FORMALITIES REQUIRED TO INCREASE CAPITAL

We have mentioned before that the capital stated in the articles of association must have been 100% subscribed at that time. And unless it has all been paid in, no more may be offered. Consequently, the governing board cannot casually sell some additional shares when the market seems favorable, and when the company needs the money.

In most kinds of companies, any addition to equity capital must start with an amendment of the charter, accomplished by a statutory majority of the shareholders. The increased capital must also be 100% subscribed before the increase is fully effective. There may be further requirements to ensure that all the subscriptions are fully paid.³⁵⁷ The principal exception is the Netherlands, in which the liberty of forming a company with only one-fifth of its capital subscribed applies also to capital increases.³⁵⁸

Two countries—France and Germany—permit the original charter to contain authorization for the capital increase. In France, a company with this power is called a stock company “with variable capital,” (*société anonyme à capital variable*) and must so describe itself. It can revise its capital downward as well as upward.³⁵⁹ In Germany, there is an arrangement known as “authorized capital” (*genehmigtes Kapital*),³⁶⁰ but it works quite differently from “authorized capital” in the United States.³⁶¹ When the decision to increase is made, the increased capital must be 100% subscribed and 20% paid in, just like the original capital. The only advantage over an amendment to increase capital is that the decision may be made by the executive board, rather than by the shareholders.

The necessity for 100% subscription of the capital which a company has power to issue is a very real one. If less than 100% is

³⁵⁷ All the limited liability laws, and some of the stock company laws are silent on increase of capital; in these circumstances, lawyers apply by analogy the provisions for original issue of capital, which have been described earlier in connection with corporate formation. Specific provisions on increasing the capital appear in Germany: AktG art. 149-158. Cf. Neth. C. Com. art. 45d, para. 2.

³⁵⁸ W.K. art. 36e; 45d, para. 2.

³⁵⁹ Law of 1867, art. 48-54. Most lawyers see no practical advantage in the use of these provisions; they prefer to form a company with fixed capital, and amend later.

³⁶⁰ AktG § 169-173.

³⁶¹ See HUECK, GESELLSCHAFTSRECHT 170-171 (2nd. ed. 1948).

subscribed, the increase is not effective; those who have subscribed are not bound to pay (unless the capital is formally reduced), and the board members are forbidden to issue shares to them.³⁶²

Naturally, European businessmen have learned to avoid any such fiasco. The simplest way is to canvass the prospective subscribers before the capital increase is authorized, so that the amount authorized may coincide with that which they will actually subscribe. This method is practical only where the new shares are to be issued to a small, known group.

A second way to escape the rigidity of the 100% subscription requirement is to put a clause in each subscription agreement that the amount of the total capital increase may be reduced without effect on the subscription. Then, when the subscriptions are all in, and their amount known, the shareholders may amend their former amendment, to adjust the capital increase to the subscriptions obtainable.³⁶³ This method is cumbrous, and may tend to cloud the atmosphere of confidence in which share subscriptions are best solicited.

A third method is to obtain 100% subscription in advance from investment bankers, who thus underwrite the risk that the investment public will not take the entire issue at the price proposed.³⁶⁴ This is the standard device used in large public financing operations. The importance of having a firm bid seems to be considerably greater than in the United States.

Although the underwriter must promise the issuer to take the entire issue, the issuer can never promise the underwriter that he will get it. The first opportunity to take the new shares generally belongs to the old shareholders. The company laws confer unconditional pre-emptive rights only in France and Germany,³⁶⁵ but these rights appear to exist in all countries, at least unless specifically negatived, as permitted by Italian law.³⁶⁶ Pre-emptive rights adhere to preferred shares as well as to common—a factor which aggravates companies' reluctance to issue preferred shares. Because of

³⁶² France: Law of 1867, art. 7, 42.

Germany: AktG § 152, 84 (executive board members liable); cf. AktG § 158.

³⁶³ Belgium: VAN RYN, DROIT COMMERCIAL no. 489 (1954); Frédéricq, 4 DROIT COMMERCIAL 494-95 (1950), quoting parliamentary debates of 1870.

France: HAMEL, DROIT COMMERCIAL 713-14 no. 591 (1954); Escarra, *Some Points of Comparison between the Companies Act, 1948, and the French Law of Companies*, 11 CAMB. L. J. 15 (1951).

³⁶⁴ Escarra, *supra* note 363.

³⁶⁵ France: Decree-Law of Aug. 8, 1935.

Germany: AktG § 153.

³⁶⁶ C. CIV. 2441.

the European recognition of indefeasible pre-emptive rights, underwriting arrangements generally have a contingent element; what the underwriter agrees to take is what the shareholders reject.³⁶⁷

C. FINANCING WITH BORROWED FUNDS

Most American investors will be much more interested in obtaining outside financing in the form of borrowed funds than in the form of stock subscriptions. Aside from the problems of divided ownership, there is the important fact that debt interest is generally deductible from taxable income (just as in the United States), while dividends on stock (even preferred stock) never are. We have been warned of only a few exceptions to the deductibility rule. In France, interest is not deductible when paid to shareholders under circumstances that lend themselves to disguised equity investments;³⁶⁸ in the Netherlands, contingent interest is sometimes non-deductible.³⁶⁹

I. TRADING ON THE EQUITY;

OBSTACLES TO THE USE OF "LEVERAGE"

Some other classical advantages of borrowing money—summed up in the phrase, "trading on the equity,"—are probably also present in Europe, but with qualifications which must not be ignored. One of the presuppositions of "trading on the equity" is that interest rates are lower than dividend rates. Here we must notice that the same kind of inversion recently observed in the United States may exist in Europe. That is, the interest rate may become higher (or at least as high as) the dividend rate. In 1959, the German Central Bank Discount rate fluctuated between 2- $\frac{3}{4}$ % and 3%, which would mean a rate of at least a percent higher to commercial borrowers. In August, the average yield on stocks listed on German stock exchanges was 2- $\frac{3}{4}$ %.³⁷⁰ Hence, the cost of equity capital was apparently lower than the cost of borrowed capital.

Perhaps the modern theory of "trading on the equity" rests not so much on a difference in contemporaneous income rates, as upon

³⁶⁷ For an interesting account of an international underwriting of a European share offering, see Bross and Alpern, *International Equity Financing*, 13 BUS. LAW. 440 (April 1958).

³⁶⁸ Professor Houin advises that deductibility is denied as to interest paid on debts owed to shareholders when (1) the interest exceeds a certain rate, or (2) the debts so owed amount to more than half the equity capital.

³⁶⁹ In cases of "participating" bonds, whose "interest" rate rises in proportion to company profits, the tax collector asserts a right to regard part of the participation as a distribution of profit, rather than a payment of interest.

³⁷⁰ First Nat. City Bank of N.Y., For. Inf. Serv., Feb., Aug., Oct., 1959.

a supposition that dividend rates will rise (in relation to the initial investment), while interest rates will not. This supposition would also be belied by important features of the European financial scene. The most important of these is the decline of fixed interest obligations, and their partial replacement by obligations which "inflate."

The inflatable securities are of three types. One type is the bond convertible into stock; it is essentially like the well known convertible debenture of American finance (although the problem of providing the shares for conversion presents special legal difficulties because of the European limitations on "authorized stock").³⁷¹ A second type is the "participating" bond, on which the interest to be paid varies with the income of the company. It should not be regarded as equivalent to the "contingent interest" bonds which were issued chiefly in reorganizations of insolvent American companies, and which had a fairly low top limit on the maximum interest to be paid (for instance, 2% fixed and 3% contingent). The European variable interest bond generally permits an unlimited increase in the income rate as the company income rises, the objective being to let the purchasing power of the interest escape from the deadly embrace of the sinking franc (or other currency).³⁷²

A third type of inflatable bond—and the most unlike any investment familiar to Americans—is the "indexed" bond, in which the interest to be paid, and the principal to be repaid, rise in proportion to increases in some official index, such as the index of wholesale prices, or the cost-of-living index.³⁷³

Obviously, all these forms of debt security diminish greatly the possibility of "trading on the equity." The convertible bond tends to limit the leverage to the time before conversion, after which the advantage disappears. The "variable interest" bond tends to take away all leverage. The indexed bond may even have a reverse leverage, if the company's profits have the misfortune to rise less than the increase in the relevant price index.

Naturally, the flight from fixed interest has been most marked in the countries where currency devaluation has been felt most sharply. In 1954, French nationalized industries borrowed 3 billions on fixed income securities, against 67 billion on participating or indexed securities, according to a study of European finance. Private industries borrowed, respectively, 9 billions and 35 billions in the

³⁷¹ ALAMIGEON, MULOT, and PLAGNOL, *LES INVESTISSEMENTS DES ENTREPRISES*, 65-71 (1958).

³⁷² Alamigeon treats this as one kind of "indexed" bond. *Id.* 64-65.

³⁷³ *Id.* 63-64.

same categories, respectively.³⁷⁴ Writing in January of 1959, our French collaborator declares, "For practical purposes, the only debt securities presently being issued by companies in France are either securities with variable interest, or convertible securities; fixed interest securities of the classic type are becoming more and more scarce." He reports that in 1957, only one billion out of 59 billions of bonds were of non-inflatable types.

However, there has been a change in the choice of inflatable media. While the earlier reports emphasized the use of what we call "indexed" bonds, the most recent issues are of the "participating" type. A financial regulation issued at the close of 1958 (contemporaneously with the relaxation of currency controls) forbade the issue of bonds indexed to the minimum wage or cost of living, but imposed no obstacles to bonds whose interest varies with the fortunes of the enterprise, as measured by revenues or profits.³⁷⁵

Apparently there has been no comparable development in other European countries. In Italy, which has also experienced severe currency depreciation, there has been little use of inflatable debt securities. Equity financing has displaced debt financing to a marked extent; in 1955, the ratio of private share issues to private bond issues was 162 to 9; and it had been growing steadily.³⁷⁶

The O.E.E.C. report on Germany also pointed to a tremendous predominance of equity issues over debt issues (156 to 9 in 1955);³⁷⁷ convertible offerings disappeared after a brief flurry in 1951 and 1952.³⁷⁸ In the Belgium-Luxembourg Monetary Union, which has had the stablest of the European currencies since 1945, there have been no notable developments of any of the three types of inflatable debt securities.³⁷⁹

2. LIMITS ON DEBT OBLIGATIONS

As in America, the principal forms of debt obligations are (1) bonds, designed for sale to a variety of investors, and (2) bank

³⁷⁴ O.E.E.C., *THE SUPPLY OF CAPITAL FUNDS FOR INDUSTRIAL DEVELOPMENT IN EUROPE* 80 (1957). This report appears to use "indexed" to include interest varying with factors extraneous to the enterprise (like the cost of living), and "participating" to designate interest varying with the gross revenues, operating income, or net profit of the enterprise.

Some later figures appear in Vasseur, *LE DROIT DE LA RÉFORME DES STRUCTURES* 181 (1959).

³⁷⁵ Ordinance of Dec. 30, 1958, portant loi de finances pour 1959, art. 79.

³⁷⁶ O.E.E.C., *op. cit.* 97.

³⁷⁷ *Id.* 82.

³⁷⁸ *Id.* 83.

³⁷⁹ *Id.* 92-93.

loans, which may be discounted among banks, but which are not available to a broad investing public.

However, many companies are incapable of issuing bonds. This is true of limited liability companies in Belgium, France, Italy and Luxembourg.³⁸⁰ This limitation is apparently based on the belief that the streamlined organization of limited liability companies deprives the investor of the protection which he has in buying the bond of a stock company. When limited liability companies borrow money, they must borrow it from banks, which are professional lenders; the rule against issuing bonds is not construed to forbid giving notes to banks. This does not mean that limited liability companies have access only to short term credit; bank loans in Europe include "medium term" and even "long term" credits.

Another distinctive limit on the use of bonds is the Italian provision which, with certain exceptions, limits the bonds which a stock company may issue to the amount of its capital stock.³⁸¹

3. SOURCES OF CREDIT

Observers of European finance over the past fifteen years stress the scarcity of investment funds during most of this period in relation to the exaggerated demands of post-war reconstruction. In addition to these factors, which operated equally on equity capital and borrowed capital, there was a special aversion to lending, inspired by the experience of inflation and the expectation of more of the same.³⁸²

Because of these factors, the European governments were obliged to create or encourage new institutions with the specific function of supplying credit to industry on a longer term than commercial banks were prepared to do.³⁸³ Most of this credit is what is called "intermediate term," ranging from one to five years, but often with an expectation of renewal so that it fulfills the economic function of true long-term credit.

In France, the outstanding institution of this type is the *Crédit*

³⁸⁰ Belgium: C. COM. I, IX, art. 131.

France: Law of March 7, 1925, art. 4.

Italy: C. CIV. 2486.

Luxembourg: Company Law art. 188 (forbidding public issue).

³⁸¹ C. CIV. art. 2410.

³⁸² See O.E.E.C., THE SUPPLY OF CAPITAL FUNDS FOR INDUSTRIAL DEVELOPMENT IN EUROPE (1957), and Supplements I and II, containing detailed studies of Finance in Austria, Germany, United States, Belgium, France, Greece, and Italy; VASSEUR, DROIT DE LA RÉFORME DES STRUCTURES INDUSTRIELLES (1959) 178 ff.

³⁸³ See O.E.E.C., *op. cit.* note 382, at 45 ff.

National.³⁸⁴ It acts by discounting notes taken by commercial banks, and rediscounting them to the Bank of France or another central bank. The net cost of the loan is based on the Bank of France discount rate plus the discounts and commissions of intervening agencies. A 1958 report indicated that the rate to a borrower would be 7.6% at a time when the Bank of France discount rate was 5%;³⁸⁵ the latter rate was reported in 1959 as low as 4¼%.³⁸⁶

In addition to the Crédit National, which extends intermediate credit, France has the Crédit Foncier, which extends long term credit secured by real estate, and some smaller semi-public credit institutions with various specialties. These institutions, including the Crédit National, are tremendously important; they are the principal source of fixed-interest credit.³⁸⁷ In a year in which private and nationalized companies succeeded in borrowing only 12 billions from the public in fixed-interest obligation, the Crédit National rediscounted 46 billions in fixed-interest notes. In the same year 64 billions were raised by private and nationalized industrial companies by participating or indexed bonds.³⁸⁸ The activities of the Crédit National may decline if the recent stabilization of the French economy results in a revival of private lending at fixed interest. But at our last reports, private industry's needs for finance depended very heavily on the Crédit National.

Semi-public and public lending institutions play a prominent role also in most of the other countries of the Market, although statistics on their activities are not equally available. In Italy, the most important three are the Istituto Mobiliare Italiano (I.M.I.), which makes direct loans to industry, and the Mediocredito which discounts industrial loans made by private banks. Both are owned by the state.³⁸⁹ In Germany, there is the state-owned Kreditanstalt für Wiederaufbau (KfW) which had outstanding loans or loan commitments of 5,790 DM in 1954, compared with 741 DM loans by the largest private long-term lender, the Industriekreditbank (I.K.B.).³⁹⁰

In Belgium, the principal resource available for intermediate

³⁸⁴ *Id.* 54 ff. Alamigeon, *op. cit.*, note 372 at 116 ff. Vasseur, *op. cit.* note 282 at 253 ff.

³⁸⁵ Alamigeon, *op. cit.* note 372, at 120.

³⁸⁶ First Nat. City Bank of N.Y., For. Inf. Serv., March 1959.

³⁸⁷ Alamigeon, *op. cit.* note 372, at 100-126; O.E.E.C., *op. cit.* 57-58.

³⁸⁸ O.E.E.C., *op. cit.* note 383 at 54, 80.

³⁸⁹ *Id.* 59-62.

³⁹⁰ *Id.* 51-54.

and long-term credit since 1946 has been the semi-public loan companies, of which only one—the Société Nationale de Crédit à l'Industrie—makes loans to industry.³⁹¹ Not only has it been the principal source of such funds, but it also offers subsidized interest rates as low as 2% for the development of facilities designed to relieve unemployment in depressed areas. Private banks also extended intermediate credit, but under substantial handicaps.³⁹² An avenue for increased industrial financing by private banks was opened by measures taken in 1959, permitting private banks to make long term loans, subsidized or guaranteed by the government.

So far as we can determine, the facilities of these public and semi-public lending institutions are just as available to American-owned enterprises as they are to locally owned ones; we know of some American-owned enterprises who have had no difficulty in using their facilities. If their attitudes differ from those of purely private lenders, it is chiefly in insisting that the borrowing enterprise should be of apparent benefit to the national economy. Although there may be a gradual expansion of the market for private financing in the coming years, we believe that many American owned enterprises will continue to find their cheapest and most satisfactory source of financing in government-owned credit institutions.

4. INTERNATIONAL CREDIT SOURCES

We have spoken of credit entirely in national terms—French credit institutions for France, Italian credit institutions for Italy. Such is certainly the existing pattern of European credit; the reasons are many and obvious. For one thing, most of the credit is not spontaneous profit-seeking activity, but is supplied directly or indirectly by the government to help the industry in the country whose government supplies the credit. The hazards of fluctuating currencies have offered a further obstacle to international credit.³⁹³

But it is obvious that if there is to be a truly European development of industry and commerce, there must be a truly European supply of credit. Two possible forerunners of a European credit supply are now visible on the horizon.

One of these is the European Investment Bank, provided for by

³⁹¹ *Id.* 62-65.

³⁹² *Id.* 35-36.

³⁹³ Byé, *Localisation de l'Investissement et Communauté Economique Européenne*, REVUE ECONOMIQUE 1958, 188.

the Treaty of Rome. Its members, and the contributors of its capital, are to be the six countries of the Community. Its purposes are stated as follows:

The task of the European Investment Bank shall be to contribute, by calling on the capital markets and its own resources, to the balanced and smooth development of the Common Market in the interest of the Community. For this purpose, the Bank shall by granting loans and guarantees on a non-profit-making basis facilitate the financing of the following projects in all sectors of the economy:

- (a) projects for developing less developed regions;
- (b) projects for modernising or converting enterprises or for creating new activities which are called for by the progressive establishment of the Common Market where such projects by their size or nature cannot be entirely financed by the various means available in each of the Member States; and
- (c) projects of common interest to several Member States which by their size or nature cannot be entirely financed by the various means available in each of the Member States.³⁹⁴

In its first two years of operation, the bank made seven loans, all of which had some special appeal to the interests of the Community. Six of these were in under-developed areas—two in southern Italy, two in southern France, one in Sicily, and one in Sardinia. The other was in Luxembourg. Four of the loans were for electric power generation, and three for chemical plants.³⁹⁵ An American company—Union Carbide—was an indirect beneficiary of one of the loans, through its part ownership in the new Italian company to which the loan was made.³⁹⁶ So far as conclusions can be drawn from so short a history, American investors are not barred from benefiting from European Investment Bank loans (at least, not when they are *joint* investors). But priorities will go to projects which promise to beget further productive products. The Bank's Board of Directors reports,

The projects to which the Bank has agreed so far, belong to the category of development investments intended for increasing basic productions which, in turn, contribute to increased demand, production, and invest-

³⁹⁴ Treaty art. 130.

³⁹⁵ European Investment Bank, Annual Report (1959) 16-19.

³⁹⁶ *Id.* (1958) 20-22.

ment in many related fields. They are nearly all situated in the less developed areas of the Community, require fairly large amounts and are by their very nature, highly capital-intensive.³⁹⁷

In the private banking sector, the commercial banks of the various countries have recognized the probable call for international loans. They are preparing for it to the extent of making contacts between banks, so that coordinated loans can be made in (for instance) francs and marks.³⁹⁸ But there is no present prospect of a single private bank which will make a loan to a wholly out-of-state company, as is done every day in New York or Chicago.³⁹⁹

D. SECURITIES REGULATION; PUBLIC OFFERINGS OF SECURITIES

It is commonly said that European countries, except Belgium, have no securities or "blue sky" laws, and no securities commissions. This is true. But this does not mean that Europe is like America would be if all the securities and blue sky laws were repealed. European countries have a considerable number of laws and regulations which restrict security offerings, and which we will briefly explain.

³⁹⁷ *Id.* (1959) 14. For further comment on the possible role of the European Investment Bank, see Vasseur, *op. cit. supra* note 382, 351 ff.

³⁹⁸ Vasseur (*op. cit.* note 382, at 357) reports the following international organizations to promote international loans:

Société Européenne de Développement Industriel, a stock company formed by one French and one German bank (the *Banque de Paris et des Pays-Bas*, and the *Deutsche Bank*) to investigate and arrange cooperation between banks and other companies of the two countries.

Société Franco-Italienne de Développement Industriel, a stock company formed by one French bank and two Italian banks (the *Banque de Paris et des Pays-Bas*, the *Banca Nazionale del Lavoro*, and the *Istituto Mobiliare Italiano*) for parallel purposes.

Groupement Franco-Allemand pour le Marché Commun, an informal association of several French and German banks to consult on concurrent participation in loans to Common Market enterprises. The banks include (for France) *Banque Française du Commerce Extérieur*, *Banque Louis-Dreyfus et Cie*, *Banque de l'Union Parisienne*, *Crédit Lyonnais*, *Société Générale*, *Société Générale Alsacienne de Banque*, and (for Germany) *Bankhaus Hardy and Co. GMBH*, *Bankhaus Sal. Oppenheim Jr. and Cie.*, *Bayerische Hypotheken- und Wechselbank*, *Dresdner Bank AG*.

Another informal association groups banks of five countries, comprising *Berliner Handelsgesellschaft*, *Crédit Commercial de France*, *Compagnie Financière de Paris*, *Banque Lambert* (Brussels), *Banca di Credito Finanziario Mediobanca* (Milan), *Compagnie d'Outremer pour l'Industrie et la Finance* (Brussels), *Pierson Heldring et Pierson* (Amsterdam), *MM. de Rothschild Frères* (Paris).

³⁹⁹ Vasseur (*op. cit.* note 382, at 357-358) prognosticates hopefully, but without detail, direct appeals by companies of one country to investors of another.

I. EXCLUSION OF LIMITED LIABILITY COMPANIES

The law about public offerings by limited liability companies is very simple. No public stock offerings of limited liability companies are permitted in any country, and no public bond offerings except in Germany.⁴⁰⁰ The theory of these laws is that the simplified structure permitted for limited liability companies—a single manager, with no watchdog auditors—affords so little investor protection that the solicitation of investment by strangers cannot be permitted.

2. REGISTRATION OF STOCK OFFERINGS

The absence of separate "securities laws" in most European countries is somewhat illusory because there are certain features built into the European stock company laws which contain the basic elements of American "securities registration," as well as features which may recall the reporting provisions of the Securities Exchange Act.⁴⁰¹

We will start with the German stock company law, which is the most elaborate. When new stock is offered, each buyer must write his signature on a declaration which discloses the number of shares of each class offered and their offering price, and names a date on which subscribers will be released if 100% of the capital has not been subscribed.⁴⁰² If shares are to be exchanged for property, the declaration must also show the name of the person making the exchange, the identity of the property, and the par value of the shares for which it is being exchanged.⁴⁰³ When all the stock has been subscribed, the company managers must file as a public record copies of

⁴⁰⁰ Belgium: As to shares, deduced from C. Com. I, IX, art. 119 (limiting number of shareholders to 50, and excluding corporations), 126 (restricting transfer) etc.; as to bonds, expressly stated by art. 131.

France: Law of March 7, 1925, art. 4 (forbidding public issue of securities of any kind).

Germany: GmbHG § 3, 5 (requiring that entire capital be subscribed by incorporators).

Italy: As to shares, the result is deduced from C. Civ. art. 2472, which forbids issuing "azioni," meaning negotiable shares. As to bonds, C. Civ. 2486 forbids their issue.

Luxembourg: Company Law art. 188.

⁴⁰¹ For some general comparisons of the regulation of security issue in United States and Europe, see Kessler, *The American Securities Act and Its Foreign Counterparts*, 44 YALE L. J. 1133 (1935); LEVY, PRIVATE CORPORATIONS AND THEIR CONTROL 408-428 (1950); Neff, *A Civil Law Answer to the Problems of Securities Regulations*, 28 VA. L. REV. 1025 (1942).

⁴⁰² AktG § 152.

⁴⁰³ *Id.* arts. 152 (1), 150.

the subscription certificates, of the contracts for issue of shares in exchange for property, a statement of the expenses of the flotation, and the governmental authorization (if required) for the offering.⁴⁰⁴ They must also publish a notice of the completed stock subscription, which includes a statement of the subscription price and of the property exchanged for shares (if any).⁴⁰⁵

In France, capital increases are treated just like the original formation of the company. Subscribers must sign a subscription contract which discloses the name, purposes, and home office of the company, which shows how many shares will be paid for in cash and how many in property, and which tells where subscription payments are to be escrowed until the required sum is completed.⁴⁰⁶ If property is exchanged for shares, there must be an auditors' report and a meeting of shareholders to approve the exchange.⁴⁰⁷ The amendment which authorized the capital increase, and a certified copy of the subscribers' list, must be publicly filed, and a notice published in the Bulletin of Compulsory Legal Notices.⁴⁰⁸

With variations in detail, there are similar provisions in the company law of Italy and Luxembourg to assure that the subscribers know what they are buying, and to make a public record of the fact of subscription.⁴⁰⁹

Only in the Netherlands is the solicitation of subscriptions substantially unregulated by law, like intra-state solicitation in Delaware and New Jersey. But the absence of legislation is supplied, at least in part, by rules on registration of securities for trading on stock exchanges. These are rules imposed by the brokerage fraternity, which, like many other professional groups in the Netherlands, exercise substantial powers of economic control. The significance of stock exchange regulations is considerable; since there is no well-developed "over the counter" market outside the exchanges, the exchanges comprise the only market that exists.

3. LICENSING OF PUBLIC OFFERINGS

In spite of the absence of "Securities Commissions," it is necessary in every country but Luxembourg to obtain either the authori-

⁴⁰⁴ *Id.* art. 155.

⁴⁰⁵ *Id.* art. 157.

⁴⁰⁶ Law of 1867, as amended by Decree of Aug. 4, 1949, art. 28.

⁴⁰⁷ Law of 1867, art. 4.

⁴⁰⁸ Law of 1867, art. 55-57, 59.

⁴⁰⁹ Italy: C. Civ. art. 2333-2336.

Luxembourg: Company Law art. 33-36.

zation or the acquiescence of some public official before a public offering is made, at least for very large offerings.⁴¹⁰

The principal difference between these systems and those of American security commissioners lies in the criteria of the authorization. In Europe, the main purpose is to prevent "disturbance of the market."⁴¹¹ Only in Belgium is the regulation of public issues avowedly designed partly to protect investors. The prevailing theory is that if too many securities were offered at a time, the market would be glutted, to the damage of all the concurrent offerors. European commentators emphasize the "thinness" of the European investment market—the limited amount of funds looking for placement. In most of the years since 1945, European markets have been "thin" as a result of the devastation of war, complicated by narrow national boundaries, which funds cannot pass without exchange permits. With financial recovery, and the recovery of vigor in European capital markets, licenses have become quite freely obtainable.

Consistent with the purpose of maintaining market equilibrium, licenses are not generally refused, but merely postponed. But they are not necessarily postponed in order of application. On the contrary, the finance ministries authorize offerings in their order of importance to the national economy. Under this test, government bond issues always come first; other issues must wait until government bond issues are fully subscribed. After that, priorities are granted on a wide variety of economic grounds; an offering which will tend to increase facilities of production for export is more desirable than one which will merely satisfy domestic consumer demands. An offering to finance a plant in a distressed area is more important than one for the same purpose in an area of labor scarcity. If there

⁴¹⁰ Belgium: Arrêté Royal No. 185 of July 9, 1935, art. 26–34.

France: Law of Dec. 23, 1946, art. 82.

Germany: Gesetz über den Kapitalverkehr, Dec. 15, 1952.

Italy: Law of May 3, 1955, No. 428 (offerings over 500 million lira—about \$750,000).

Netherlands: No statute requires licensing, but (1) by a gentleman's agreement brokers will not handle the shares unless the offering has been approved by the Nederlandse Bank, and (2) the Minister of Justice will withhold permission for any incorporation or charter amendment until he is satisfied with respect to the financing plans.

⁴¹¹ The Belgian law discloses two purposes; the offering can be postponed because of a tendency to "déséquilibrer le marché des capitaux" (art. 28) Arrêté Royal of July 9, 1935, or to "induire les souscripteurs en erreur." (art. 29), Arrêté Royal, No. 185 of July 9, 1935. The French law declares no purposes, but it is attached to a government budget bill, and is reportedly administered chiefly to protect the market for government bonds.

Under the German law, "Die Genehmigung kann versagt werden, wenn Zinssatz, Ausgabe- und Rückzahlungsbedingungen bei gleichartigen Wertpapieren wesentlich abweichen und bei einer Genehmigung eine nachhaltige Störung des Kurs- und Zinsgefüges am Kapitalmarkt zu befürchten wäre."

is a national plan of industrial development, as in France, conformity to the national plan will be important.

Another difference in result which flows from the difference in purpose is that when money is "easy," licenses are granted with great freedom, or a "general license" is granted, which means in effect a suspension of the regulation.⁴¹²

4. THE BELGIAN BANKING COMMISSION

Two years after the adoption of the federal Securities Act in the United States, Belgium created a "Banking Commission," with powers over the public issue of securities.⁴¹³ Probably the primary object of the creation was the supervision of banks, and enforcement of the divorce, ordered by the same law, of investment functions from commercial banking functions.⁴¹⁴ In any event, the Belgian Banking Commission, as its name suggests, supervises banking in general as well as securities issues.

The powers of the commission over securities issuance rest on the narrow basis of the power to postpone for a maximum of three months the issue of securities, and to publish its decision (with reasons).⁴¹⁵ When one thinks of the great power wielded by the American Securities Exchange Commission through granting or withholding the acceleration (by a maximum of 20 days) of the effective date of registration statements,⁴¹⁶ one can perhaps appreciate better the de facto influence of the Belgian commission.

The Commission's decision to prohibit (temporarily) may be based on either of two grounds—that the offering is likely to unsettle the capital market,⁴¹⁷ or that it is likely to mislead investors as to the character of the business or the rights conferred by the securities.⁴¹⁸ In order to inform itself, the Commission is entitled to a dossier which might be called a short registration statement, and such further information as it may request which may be useful to it.⁴¹⁹

Through its power to delay a license, or compel disclosure, or

⁴¹² Alamigeon, *op. cit.* note 371 *supra*, at 76.

⁴¹³ Arrêté Royal No. 185 of July 9, 1935; for a full examination of this decree and the operations under it, see PONLOT, *LE STATUT LÉGAL DES BANQUES ET LE CONTRÔLE DES ÉMISSIONS DE TITRES ET VALEURS* (1958).

⁴¹⁴ See the Report accompanying the decree, printed in Ponlot, *op. cit. supra* note 413, at 314-324; see also O.E.E.C., *THE SUPPLY OF FUNDS FOR INDUSTRIAL DEVELOPMENT IN EUROPE AND THE UNITED STATES*, 35-36 (1957).

⁴¹⁵ Arrêté Royal No. 185, July 9, 1935, arts. 28, 29.

⁴¹⁶ LOSS, *SECURITIES REGULATION 175-178* (1951).

⁴¹⁷ Arrêté Royal No. 185, July 9, 1935, art. 28.

⁴¹⁸ *Id.* art. 29.

⁴¹⁹ *Id.* art. 27, 28.

both, the Commission has exercised a profound influence over many phases of corporation financial practice which have no immediate relation to public offerings. Believing that the purchase of treasury shares is a dubious practice, the Commission has induced one company to adopt provisions (presumably charter amendments) to prevent repetition; another company was induced to cancel treasury shares, to preclude reissue.⁴²⁰ Where affiliated companies had bought shares in each other, the Commission induced both to liquidate their holdings.⁴²¹ Where shares are issued over par, the Commission requires that the surplus be placed in a reserve, unavailable for dividends.⁴²²

The Commission has taken a very lively interest in profit-sharing plans of executive compensation, which have had great post-war popularity in Belgium. Many profit sharing plans are based, it appears, on the excess over some quantity of profit established many years ago, and now outdated by inflation or other factors. In these cases, the Commission believes that the compensation plan should be revised to raise the profit base above which the profit-sharing plan operates.⁴²³ Taking a leaf from American practice, the Commission has decided to require a listing of the compensation of the governing board members and top executives, with the compensation of each, and each one's qualifications.⁴²⁴ However, the registration statement is not a public document, and the prospectus is not required to do more than show the total remuneration to the governing board members as a group.

The Commission engages in a host of other activities, none of which will amaze an American familiar with the activities of the S.E.C., but most of which are foreign to European practice. It requires the disclosure of underwriting arrangements and underwriting expenses.⁴²⁵ It requires disclosure that the company has paid a board member's expenses of legal defense, or that board members have conflicts of interest with the corporation.⁴²⁶ In one case it influenced a company with subsidiaries to present a consolidated balance sheet—a rare practice in Europe.⁴²⁷ It has also introduced

⁴²⁰ Ponlot, *op. cit. supra* note 413, at 231, 232.

⁴²¹ *Id.* 237.

⁴²² *Id.* 235.

⁴²³ *Id.* 239-41.

⁴²⁴ *Id.* 264.

⁴²⁵ *Id.* 251-52.

⁴²⁶ *Id.* 255-56.

⁴²⁷ *Id.* 267. Officials of Esso-Standard (France) advised us that they had introduced a consolidated balance sheet in France in the late 1950's, hoping that other companies would follow suit; but no others did.

the use of comparative profit and loss statements covering a period of years.⁴²⁸

These items will suffice to show that the Banking Commission, with a relatively small staff and small statutory basis, has an influence in many directions which recalls securities regulation in Washington. The fact that it is alone in doing so will emphasize, at the same time, the absence of similar securities regulation in the other countries of the market.

E. A COMMON MARKET FOR CAPITAL?

Our dominant impression, as we look at the prospects for European investment, is very different from our impression of the prospects for trade in commodities. For commodities, we envision by 1970 a truly common market, in which the same kinds of typewriters will be sold and used in Hamburg as in Palermo, with no more difference in price than the cost of commercial freight. They cannot be scarce in Amsterdam and plentiful in Venice, nor can the available kinds and qualities vary greatly.

The capital markets are quite different. We start out with different company laws, which limit the kinds of securities which companies can issue. German and French companies can make the same kinds of typewriters, but German limited liability companies can issue bonds, while French cannot. French stock companies' preferred stock must have voting rights, but German need not. Besides, even the tastes of investors have changed; French investors demand inflatable bonds; Germans and Belgians will (to a greater extent) accept fixed interest.

The prospects are also different. While there is a definite schedule for eliminating customs and quotas at an arithmetic rate,⁴²⁹ there is no such formula for eliminating barriers to capital movement. There is not even a firm promise to eliminate them entirely, but only "to the extent necessary for the proper functioning of the Common Market."⁴³⁰ These weasel words invite wide differences of opinion as to what kind of functioning is "proper" in the capital markets; if such differences had not existed, it would not have been necessary to use such weasel words.

Although the nations pledge themselves to "co-ordination of exchange policies,"⁴³¹ they say nothing about the licensing of investment offerings, except what may be implicit in the promise to

⁴²⁸ *Id.* 270-71.

⁴²⁹ Treaty arts. 12-17, 30-37.

⁴³⁰ *Id.* art. 67.

⁴³¹ *Id.* art. 70(1).

"approximate" laws of all kinds which "distort the conditions of competition."⁴³² We must therefore reconcile ourselves to a long-term continuance of the present diversity of the measures and policies of regulation.

However, diversity alone need not block the development of an international market. There is an interstate market for capital in the United States, despite the rigors of, and the irrational differences between, the blue sky laws of Illinois and Michigan. It exists partly because the companies can escape to Delaware, and the money can escape to New York, where the requirements of only one state and of the federal government must be met.

To draw a parallel in Europe, we might ask whether European investors' money can escape to Luxembourg—a country of notorious freedom from exchange regulations, and whether companies which operate in Italy, Germany, and Belgium would turn to this market for money on similar terms of investment?

To answer this question, we will start by saying that we think that to some extent this is already happening. The curtain of exchange control is not a curtain of iron, and it will become less and less effective as commerce among the nations of the Market expands. An official of the Belgian Banking Commission told us that he thought the Commission's controls were evaded in a number of cases by investments effected in Luxembourg; this is particularly easy, because there is no exchange control at all between these two countries. (They have a monetary union.)

But we think that the growth of a Community-wide capital market will be very slow, and will depend on the solution of many problems which are not envisaged by the Treaty of Rome. There will first have to be a unanimous desire, which evidently did not exist when the Treaty was signed, to establish a common capital market. Next, there will have to be a total and permanent relaxation of exchange controls.

Before that will come to pass, we think there will have to be a general agreement on what kinds of controls over investment are necessary and proper, and there will have to be confidence among the investors of the various countries that the investments available in other countries are as safe as those in their own. This kind of confidence is not likely to arise until similar controls, or common controls, exist in the various countries. Perhaps this will come about through "approximation of laws." But an American finds it difficult

⁴³² *Id.* art. 101.

to imagine uniformity in investment standards without the existence of an interstate agency with direct regulatory powers, like the Securities Exchange Commission. Since the Treaty of Rome does not provide even a skeleton for such regulation, a European common capital market as Americans know it appears to be along way off.

For the American businessman, this means that if he wants to raise money in Europe, he will probably have to raise it in the country where he plans to use it. Even though some of the ultimate investors may reside in other countries, the money will be raised according to the usages and regulations of the country where the industrial operation is located. Hence the choice of site of operation will be made with an eye on investment conditions as well as on merchandise and labor markets.

A good location, from a financial point of view, is one in which investment capital is fairly plentiful, the usual investment media (e.g. convertible bonds, fixed interest bonds) are acceptable, and in which money once invested, and its profits, can be freely withdrawn and invested in other countries of the Community, or returned to the United States. The choice is the more difficult to make because it depends on future controls, rather than present ones. According to common knowledge, Belgium and Luxembourg have enjoyed the longest monetary stability (since 1946), with accompanying freedom of exchange control. Germany has been in the same group since about 1950. Netherlands currency has been stable, but exchange control has been fairly tight. Italy and France, in that order, have most recently attained monetary stability, and have the strictest currency controls today. The investor must guess what the respective advantages of the various countries will be tomorrow.

POSTSCRIPT

The lawyer's job in planning a business operation—whether foreign or domestic—may be thought of as involving two parts: conception and communication. The lawyer must first form a mental picture of the company structure that he wants to set up, and of the roles which the various officials will play, individually and in relation to each other. Next, he must somehow communicate these ideas to the officials who are to do the acting.

On the domestic scene both parts of the job may be carried out almost unconsciously, because the lawyer conceives of a structural

pattern which is completely traditional, and anyone who is named as president of a parent company, or president of a domestic subsidiary, has the same conception as the lawyer of how he is supposed to act.

When the American lawyer turns to a foreign business operation, both processes are greatly complicated. The complication of the communication process is obvious. An American "director" is not the equivalent of an Italian *dirretore*. Even if the "director" is equated with the more nearly comparable *amministratore*, the problem is not solved, because the *amministratore* also thinks of himself rather differently than does an American "director."

But the difficulty is one of conception as well as of communication. The European institutions, and the roles which people play within them, are just a little different from the institutions which exist, and the roles which are played, in the United States. The American lawyer is in the position of a composer writing music for people who not only use a different system of musical notation but also play different instruments on different scales than those which he knows.

Many American lawyers—of necessity—probably ignore these differences. They make their plans in terms of Delaware certificates of incorporation, Delaware boards of directors, and Delaware capital and surplus. Their instructions may be quite impossible of execution within a foreign legal system. Most of this impossibility will go undetected on both sides, because the faithful foreign agents will carry out (in Italian) whatever seems to them the most plausible interpretation of the American wishes. They will then report their action (in English) in the terms of the instructions.

So long as this system works, there is no reason to change it. It probably is much better than it would be if the American lawyers succeeded in recreating on the Italian scene a corporate structure duplicating precisely the one in Detroit.

But the stiffer competition of the emerging Common Market is likely to demand something better. American enterprises will reach their full potential only if some of their management know-how is effectively transferred to Europe, and if errors in management are efficiently located and corrected. This means that the American lawyer who bears responsibility for the organization of a European business operation needs to know—like a composer—something about the musicians who will perform his piece, the instruments they play, and the notations which they recognize. Learning these

things is an endless task, and the American lawyer will never know them all. But every bit that he learns about the laws and the institutions of Common Market countries will contribute a little to his ability to design and control the Common Market operations of an American enterprise.

Chapter IX

The Significance of Treaties to the Establishment of Companies

Thomas L. Nicholson *

I. INTRODUCTION

A study by an American lawyer of laws relevant to an American corporate client which is to be established in the Common Market area must take some account of international legislation—the bilateral or multilateral treaties involving the United States and the six members of the European Economic Community, those between or among Community countries, and those involving Community members and third countries other than the United States. A number of the international agreements to which the United States and Common Market countries are parties—the General Agreement on Tariffs and Trade ¹ and the International Convention for the Protection of Industrial Property,² for example—are discussed in other chapters. The principal treaty among Community members of relevance is, of course, the Treaty establishing the European Economic Community, the central focus of this book. A review of the treaties between or among Community members and non-members other than the United States is generally beyond the scope of this discussion.

Attention will therefore be centered on the effect of “treaties of commerce”³ between the United States and various Community members, and of the E.E.C. Treaty, on conditions of doing business within the Community. Some areas in which treaties may be signifi-

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¹ See Ouin, *The Establishment of the Customs Union*, Chapter III *supra*.

² See Ladas, *Industrial Property*, Chapter V *supra*.

³ The phrase “treaties of commerce” has been coined to embrace both the traditional treaties of Friendship, Commerce, and Navigation (F.C.N. treaties) and those exemplified by the Convention of Establishment with France.

cant to an American corporate investor are considered—in general areas not touched on in other chapters of this book.⁴ The aims are: (1) to suggest, by a detailed discussion of one treaty of commerce, the potential importance of such treaties to the establishment by an American corporation of branches or subsidiaries in the Community; (2) to point up comparisons between the treaty discussed and the E.E.C. Treaty which are of general relevance; (3) to indicate the interrelationship of the relevant treaties of commerce and the E.E.C. Treaty; and (4) to indicate the possible significance of the E.E.C. Treaty to the subsidiary of an American corporation established in one Community country and doing business in some or all of the other Member States.

II. TREATIES OF COMMERCE

Treaties of commerce between the United States and Italy, the Netherlands, and Germany respectively are already in effect, and the Convention of Establishment between the United States and France was recently signed, although it has not yet been ratified.⁵

A. TREATIES OF COMMERCE IN GENERAL

The basic aim of treaties of commerce is to establish a standard of conduct which each signatory owes to the nationals and companies⁶ of the other. "National treatment" is in most provisions the measure of each signatory's duty—neither may discriminate against the nationals or companies of the other state in favor of its own. The "most-favored-nation" clause—neither state may discriminate against the nationals or companies of the other in favor of any other aliens or alien companies—sometimes applies,⁷ however,

⁴ Chapter VIII *supra*, *Organizing for Business* by Professor Conard (hereinafter cited as Conard, ch. VIII) is sometimes a point of departure, however.

⁵ Treaty of Friendship, Commerce, and Navigation with the Italian Republic (hereinafter cited as Italian F.C.N. Treaty) (effective Aug. 5, 1949), U.S. Dep't of State, *Treaties and Other International Agreements Series* (hereinafter cited as T.I.A.S.) No. 1965; Treaty of Friendship, Commerce, and Navigation with the Federal Republic of Germany (hereinafter cited as German F.C.N. Treaty) (effective July 14, 1956), T.I.A.S. 3593; Treaty of Friendship, Commerce, and Navigation with the Netherlands (hereinafter cited as Dutch F.C.N. Treaty) (effective Dec. 5, 1957), T.I.A.S. 3942; Convention of Establishment with France (hereinafter cited as the Convention with France) 41 Dep't of State Bulletin 828 (Dec. 7, 1959).

⁶ Companies are mentioned only in U.S. treaties of commerce concluded since the Second World War. See Walker, *Provisions on Companies in United States Commercial Treaties*, 50 AM. J. INT'L L. 373 (1956).

⁷ *E.g.*, with respect to payments, remittances, and transfers of funds or financial instruments between the United States and France. Convention with France, art. X, para. 1.

and, in a few instances, both standards must be met or some third criterion is applicable.⁸

A number of areas of activity are regulated,⁹ but treaties of commerce "are above all treaties of establishment, concerned with the protection of persons, natural and juridical, and of the property and interests of such persons."¹⁰

To indicate the general nature and scope of this protection, but more particularly to suggest some practical differences a treaty of commerce can make, only the Convention with France will be discussed because a full-scale consideration of the four relevant treaties would be both unwieldy and unwarranted. The choice of the Convention with France is essentially arbitrary, although in part dictated by the fact that it was the last of the four to be elaborated.

B. THE CONVENTION WITH FRANCE

The Convention with France is generally representative in content of the three other treaties of commerce here relevant, with one obvious difference which is reflected in its name. It is called "Convention of Establishment" rather than "Treaty of Friendship, Commerce and Navigation" because it excludes rules concerning trade and shipping and focuses on questions of investment or, more broadly, on the protection of persons and property.¹¹

I. THE PROTECTION OF ESTABLISHMENT GENERALLY

By virtue of Article V of the Convention with France, U.S. companies "shall be accorded national treatment with respect to engaging in all types of commercial, industrial, financial and other activities for gain" in France "whether directly or through the intermediary of an agent or any other natural or juridical person." Included in the activities of American companies which are accordingly permitted in France are: (1) the establishment and maintenance of "branches . . . and other establishments appropriate to the conduct of their business"; (2) the organization of "com-

⁸ E.g., "fair and equitable treatment" is the enunciated standard of Article 1 of the Dutch F.C.N. Treaty.

⁹ See Walker, *Modern Treaties of Friendship, Commerce and Navigation*, 42 MINN. L. REV. 805, 808 (1958) for an outline of their usual content.

¹⁰ *Id.* at 806.

¹¹ Walker, *Convention of Establishment Between the United States and France*, 54 AM. J. INT'L L. 393, 394 (1960). In the following discussion only the protection of American companies in France will be referred to although the Convention with France of course protects French companies in the United States and natural as well as juridical persons in both countries.

panies under the general company laws"; (3) the acquisition of "majority interests in [French] companies"; and (4) the control and management "of the enterprises which they have established or acquired." The Convention further assures American corporations with interests in France: (1) that their property, enterprises, and other interests will be accorded "equitable treatment," and that they will be granted "full legal and judicial protection" (Article I); (2) that their "lawfully acquired rights and interests . . . [will] not be subjected to impairment [within France] . . . by any measure of a discriminatory character" (Article IV, paragraph 1); (3) that their "offices, warehouses, factories and other premises . . . [located in France] . . . [will] be free from molestation and other unjustifiable measures" (Article IV, paragraph 2); and (4) that they will "not be subject to any form of taxation or any obligation relating thereto . . . [within France], which is more burdensome than that to which . . . companies [of France] . . . in the same situation are or may be subject" (Article IX, paragraph 2 (c)), nor "to any form of taxation [within France] upon capital, income, profits or any other basis, except by reason of the property which they possess within those territories, the income and profits derived from sources therein, the business in which they are there engaged, the transactions which they accomplish there, or any other bases of taxation directly related to their activities" within France (Article IX, paragraph 4).

In addition American corporations may claim national treatment in respect: (1) to "leasing and acquiring, by purchase or otherwise, as well as with respect to possessing, personal property of every kind, whether tangible or intangible" (subject to exceptions concerning ships and public safety) (Article VII, paragraph 2); and (2) to "obtaining and maintaining patents of invention and with respect to rights appertaining to trade-marks, trade names and certification marks, or which in any manner relate to industrial property" (Article VIII, paragraph 1).

There are obvious omissions in this general outline of the rights accorded by the Convention with France to an American corporation doing business in France. The most significant omissions will be discussed in some detail because they afford examples of the importance which the Convention may have to the American corporate investor. They will be discussed in a rough chronological order—beginning with those which might first in time be of interest

to an American corporation establishing branches—or, in some cases, subsidiaries—in France.

2. THE COMPANIES PROTECTED

Article XIV, paragraph 5 of the Convention provides: "Companies constituted under the applicable laws and regulations . . . [of one of the states of the United States] shall be deemed companies . . . [of the United States] and shall have their juridical status recognized . . . [in France]."

Under this provision a corporation formed in any state of the United States will be recognized in France as an American company and therefore a juridical entity even if its central office¹² (*siège réel*) is located in Paris—and this is true despite the French conflict rule under which a company's "nationality" is determined by the location of its central office.¹³ In other words, the "Delaware" of France (and of the Common Market countries other than Belgium and Luxembourg)¹⁴ could be—tax and other considerations aside—Delaware.

But the place of formation is not the sole factor determining which companies are to be given protection in France by the Convention. Article V, paragraph 1 (last sentence) provides:

. . . the enterprises which . . . [American nationals or companies] control . . . whether in the form . . . of a company or otherwise, shall, in all that relates to the conduct of the activities thereof, be accorded treatment no less favorable than that accorded like enterprises controlled by nationals and companies of . . . [France].

This provision means in effect that some *French* companies—that is, those formed in France by American nationals or corporations—can claim protection under the Convention against discrimination by *French* laws or administrative acts. Its intent, of course, is to prevent discrimination against those French enterprises in which Americans have invested and which are not protected by the provisions relating to American companies or nationals.

¹² This is understood to mean the place where ultimate decisions are made. See Conard, ch. VIII, text at notes 117 and 118, *supra*.

¹³ *Ibid.* Although strictly speaking, a company has no nationality (see *e.g.*, SAVATIER, *COURS DE DROIT INTERNATIONAL PRIVÉ* 34 (2d ed. 1953)), that term will be hereinafter used as shorthand to denote the country whose laws determine such things as its validity, whether it has juridical personality, its powers, and the rights of its stockholders.

¹⁴ See Italian F.C.N. Treaty, art. II, para. 2; German F.C.N. Treaty, art. XXV, para. 5; Dutch F.C.N. Treaty, art. XXIII, para. 3.

A third criterion, residence, may sometimes be relevant. Article XIV, paragraph 1, in defining "national treatment" limits it to nationals and companies "in like situations," and paragraph 16 of the Protocol to the Convention provides: "Residence criteria may be applied for purposes of determining whether or not nationals and companies . . . are in 'like situations' . . ."

In sum, a corporation formed in one of the United States will be recognized in France as American and a juridical entity wherever its central office or center of activity (for example, its main manufacturing plant) is located. It, or its subsidiaries formed in France, may claim national treatment under the Convention, but location of the central office, or of the center of activity, of it or its subsidiary—presumably the "residence criteria" of a company¹⁵—may determine what national treatment means.

3. EMPLOYMENT OF NON-NATIONALS

American corporations or their subsidiaries are generally free to employ non-French personnel in France, but the persons employed are subject to regulations which could result in significant restrictions on them.

Every foreigner who wishes to remain more than three months in France must have the authorization of the Ministry of Interior.¹⁶ In addition, if he wishes to act as President of the supervisory board (*Président de Conseil d'administration*) of a stock company, as manager (*gérant*) of a limited liability company, or as the manager (*directeur*) of an agency or branch of a foreign company, he must have a *carte d'identité de commerçant* (hereinafter "foreign merchant's identity card").¹⁷

This foreign merchant's identity card is: (1) good only for the occupations authorized and only for the departments (*départements*) of France mentioned therein; (2) temporary, being limited in duration by the duration of the authorization to remain in France; (3) a concession of the state, which the administration may refuse

¹⁵ It is possible, however, that the location of a branch might be determinative of a company's residence for certain purposes, if such a conclusion were advantageous to the beneficiary of the treaty right.

¹⁶ *Carte de séjour* (hereinafter referred to as "authorization to remain"); see *Ordonnance* No. 45-2658 (hereinafter referred to as "Order") of Nov. 2, 1945, art. 6, [1945] *Journal Officiel de la République Française* (hereinafter cited as "J.O.") 7225; *Décret* 46-1574 (hereinafter referred to as "Decree") of June 30, 1946, art. 3, [1946] *J.O.* 5920-21 and 6169.

¹⁷ See Decree of Feb. 2, 1939 (*relatif à la délivrance des cartes d'identité de commerçant pour les étrangers*), [1939] *J.O.* 1645.

in its discretion, not a right (and if the identity card is refused, the applicant has no recourse); (4) renewable; and (5) subject to cancellation under certain conditions (bankruptcy, conviction of a crime, false declarations).¹⁸

Moreover, failure to obtain the required foreign merchant's identity card can result in fines, the closing of the enterprise involved, and even, apparently, the nullity of certain acts (for example, the formation of a limited liability company with alien *gérants* who have no foreign merchant's identity card may be held null and void).¹⁹

The reason for the existence of identity cards has been indicated by Professor Savatier of the Paris Law Faculty:

[I]t soon [in the 1930's] became clear that workers were not alone in demanding protection against all excessive foreign competition. The principal occupations [*professions*] were no doubt already reserved to Frenchmen by more or less strict monopolies. . . . But it was necessary, outside this restricted area, to give thought to the protection of Frenchmen against various foreign heads of business enterprises [*chefs d'entreprises*].²⁰

If one adds the fact that local chambers of commerce and professional organizations play an advisory role in the issuance of foreign merchants' identity cards,²¹ it is clear that the position of U.S. corporations which desire to put Americans in charge of their French operations could be a difficult one. In fact, it apparently has not been; and their legal position will be significantly improved once the Convention with France has gone into effect.

The Convention contains a number of provisions which are relevant. Article II, paragraph 1 (a) and (b) create a "treaty trader" and a "treaty investor" class of American nationals who must be permitted to enter and remain in France²² for the purpose of carrying on trade between the two countries or of "developing and

¹⁸ See Chaine, *Le Statut Professionnel de l'Étranger en France*, in *LE STATUT DE L'ÉTRANGER ET LE MARCHÉ COMMUN* (57^e Congrès des Notaires de France, 1959) at 157.

¹⁹ *Id.* at 188.

²⁰ Savatier, *À Propos des Cartes de Commerçants*, *RECUEIL DALLOZ DE DOCTRINE DE JURISPRUDENCE ET DE LÉGISLATION* (hereinafter cited as D.) *CHRONIQUE* 21, 22 [1953]. (Translation by this author.)

²¹ Decree of Feb. 2, 1939, art. 8, [Feb. 4, 1939] J.O.

²² Subject to the "laws relating to the entry and sojourn of aliens" (art. II, para. 1) (e.g., to the requirement in France that aliens obtain an authorization to remain) and to measures of public order, health, morals, and safety (art. II, para. 3). As to "treaty traders and investors," see Wilson, "*Treaty-Investor*" *Clauses in Commercial Treaties of the United States*, 49 AM. J. INT'L L. 366 (1955).

directing the operations of an enterprise in which they have invested, or in which they are actively in the process of investing, a substantial amount of capital." Moreover, by virtue of Paragraph 2 (c) of the Protocol, Americans proceeding to France "for the purpose of occupying a position of responsibility in an enterprise" on behalf of "treaty investors" must also be permitted to enter and remain in France.

The significant point here is contained in paragraph 2 (a) and (b) of the Protocol. Under paragraph 2 (a) "the laws and regulations in force . . . [in France] which govern the access of aliens to the professions and occupations, as well as the exercise of such callings and other activities by them, remain applicable . . . [to American nationals and companies]." Under paragraph 2 (b), however, "the procedures provided for by the above-mentioned laws and regulations, as well as those provided for by laws and regulations governing entry and sojourn of aliens, must not have the effect of impairing the substance of the rights set forth in Article II, paragraph 1 (a) and (b)" (that is, of the rights of "treaty traders" and "investors" or of Americans going to France to occupy positions of responsibility in the enterprises of "treaty traders" or "treaty investors").

The result of these provisions is threefold: (1) authorizations to remain in France and foreign merchants' identity cards will still be required; (2) the issuance and renewal of foreign merchants' identity cards to American nationals wishing to exercise a company function for which such identity cards are required will no longer be subject to the discretion of the competent prefects—or to the adverse recommendations of competitors: qualifying Americans will have a *right* to identity cards; (3) in cases of abuse, American nationals will have recourse to French administrative tribunals, and should their decisions, in the view of the United States government, violate the Convention with France, the United States State Department may make complaint to the French Government, and, if need be, the United States may bring action against France in the International Court of Justice.

Other American personnel to be employed in France—whether technicians or executives—must have a work permit,²³ and if they

²³ *Carte d'identité professionnelle de travailleur* or *carte de travail*, see Order No. 45-2658 of Nov. 2, 1945, [1945] J.O. 7225; Decree No. 46-1340 of June 6, 1946, [1946] J.O. 5018-19.

are accountants, technical experts, or lawyers, they must, subject to one exception, have fulfilled the conditions "necessary to the exercise of their calling under the applicable [French] legislation."²⁴ The exception is stated in the succeeding paragraph which will permit:

. . . [American] companies . . . to engage accountants and other technical experts, who are not nationals of . . . [France], without regard to their having qualified to practice a profession within the territories of . . . [France], but exclusively for conducting studies and examinations for internal purposes on behalf of such . . . companies.²⁵

The significance of this provision is emphasized by the fact that Article II of the French Civil Code permits nationals of another country to exercise rights in France only to the extent that Frenchmen are permitted to exercise similar rights in that country. Moreover, a Joint Declaration appended to the Convention states the intention of the United States and France to facilitate "to the greatest possible extent and on a basis of real and effective reciprocity . . . the establishment of . . . qualified personnel who are indispensable to the conduct of the enterprises created by nationals and companies" of either country within the territory of the other.

4. OWNERSHIP OF REAL PROPERTY

Article VII, paragraph 1 of the Convention with France guarantees national treatment to American nationals and companies "with respect to leasing, utilizing and occupying real property of all kinds appropriate to the exercise of the rights" accorded them by the Convention.

This will have at least one consequence of significance. A concept of "commercial property" (*propriété commerciale*) has developed in French law according to which the lessee of commercial property has a right to an eviction indemnification if renewal of his lease is refused by the lessor. The applicable law²⁶ has the effect of denying this renewal right to foreigners unless, *inter alia*, they enjoy national treatment by virtue of an international treaty.²⁷ Article VII

²⁴ Convention with France, art. VI, para. 1.

²⁵ *Id.* para. 2. Paragraph 9 of the Protocol to the Convention adds that the provisions of paragraph 2 are adopted "until such time as it may have become possible to conclude an agreement concerning the exercise of . . . [accountancy]."

²⁶ Decree 53-943 of Sept. 30, 1953, [1953] J.O. 8602.

²⁷ See Richemont, *Les Ressortissants des pays, faisant partie du Marché Commun*,

of the Convention with France plainly fulfills this requirement as far as American nationals and companies are concerned.

5. RIGHT TO SUE IN FRENCH COURTS²⁸

Article III, paragraph 1 of the Convention with France ensures American nationals and companies national treatment with respect to access to French "courts of justice as well as to administrative tribunals and agencies."²⁹ This provision will not affect, however, the duty of American corporate or individual plaintiffs as aliens to post bond (*donner caution*) to guarantee the payment of costs and damages assessed against them in actions they initiate.³⁰

6. VOLUNTARY TERMINATION OF BUSINESS ACTIVITY

An American company which decides to terminate its activities in France is guaranteed by the Convention with France national treatment in regard to the right to dispose of property of all kinds³¹ and to taxation.³² More importantly, the Convention subjects France to four duties concerning repatriation of funds: (1) it must accord to an American company the same treatment with respect to payments, remittances, and transfers of funds or financial instruments between France and the United States or any third country as it would to a French company in a like situation (that is, for example, to one "residing" in the United States);³³ (2) it must accord to an American company the same treatment in this respect as it would to the company of any third country in a like situation;³⁴ (3) it must make "reasonable provision for the withdrawal of earnings";³⁵ and (4) it must "make every effort to accord in the greatest possible measure . . . [to an American company] the oppor-

peuvent-ils bénéficier de la propriété commerciale en France, LE DROIT EUROPÉEN 380 (No. 10, May, 1959).

²⁸ Cf. Wilson, *Access-to-Courts Provisions in United States Commercial Treaties*, 47 AM. J. INT'L L. 20 (1953).

²⁹ Moreover, American companies *not* engaged in activities in France may not be required to register as a condition of the exercise of this right (art. III, para. 1) and right of access to the courts and recognition of juridical status (unlike other advantages of the Convention) may not be denied to companies formed in accordance with the laws of any one of the United States merely because they are controlled by non-Americans (art. XIII).

³⁰ See art. 16 of the Civil Code of France. Foreigners who own real estate of sufficient value in France to assure such payment are exempted.

³¹ Art. VII, para. 3.

³² Art. IX, para. 1(c).

³³ Art. X, para. 1.

³⁴ *Ibid.*

³⁵ Art. X, para. 3.

tunity . . . to repatriate the proceeds of the liquidation . . . [of its branches in France].”³⁶

These four duties are subject to three limitations. France may: (1) impose exchange restrictions “to the extent necessary to prevent its monetary reserves from falling to a very low level or to effect a moderate increase in very low monetary reserves”;³⁷ (2) impose “particular restrictions whenever the [International Monetary] Fund specifically authorizes or requests”³⁸ it to do so; and (3) treat different currencies differently as may be required by the state of its balance of payments.³⁹

An American company which liquidates a branch or subsidiary in France will be able, in summary, to count with some certainty on a repatriation of its earnings, and it will have important guarantees that repatriation of its capital will also be possible.

7. EXPROPRIATION

The Convention with France will also afford significant protection to American corporate branches and subsidiaries in France against expropriation of their property. Expropriation is prohibited by Article IV, paragraph 3 “except for a public purpose and with payment of just compensation.” More importantly, just compensation is defined as “the equivalent of the property taken . . . in an effectively realizable form.” Compensation must be accorded “without needless delay,” and “adequate provision for the determination and payment of the said compensation must have been made no later than the time of the taking.” If compensation so measured is less than that afforded French nationals whose property has been similarly expropriated, or if payment to them is more prompt, American companies may invoke the national treatment clause of paragraph 4 of Article IV; they may, in short, invoke whichever of two standards is, in fact, the more advantageous. France is, furthermore, again under a duty “to make every effort to accord in the greatest possible measure the opportunity . . . to repatriate the proceeds. . . .”⁴⁰

The Protocol adds two important clarifications. Paragraph 5 states that “expropriation” means, *inter alia*, “nationalization”; and paragraph 6 extends the protection of Article IV, paragraph 3 to

³⁶ *Ibid.*

³⁷ Art. X, para. 2.

³⁸ *Ibid.*

³⁹ Protocol, para. 13.

⁴⁰ Art. X, para. 3.

interests held directly or indirectly by American companies in expropriated property.

III. THE CONVENTION WITH FRANCE AND THE E.E.C. TREATY COMPARED

At this point the perspective of the discussion shifts: the assumption is that the American parent company has formed a Common Market subsidiary; for the sake of example and to facilitate comparisons with the Convention with France, it is further assumed that the subsidiary is located not in France but in Belgium (hereinafter this assumed company will sometimes be referred to simply as the "Belgian subsidiary"). Most of the questions considered relate to treaty protection of the operations and branches of this assumed Belgian subsidiary in other Common Market countries and usually in France.

A. GENERAL COMPARISONS

Before comparing in detail the provisions of the Convention with France with their counterparts in the E.E.C. Treaty⁴¹ some general comparisons are useful.

(1) The provisions of the Convention with France are in the main self-executing and will therefore become applicable in France without legislation or executive action as soon as the Convention goes into effect. The right-of-establishment provisions of the E.E.C. Treaty with few exceptions⁴² require implementation by directives, and by a general program to be given effect by directives, adopted by the Council before December 31, 1961.⁴³

(2) The Convention with France spells out a number of specific rights which American companies will enjoy in France. The E.E.C. Treaty is directed at protection of the "freedom of establishment," defined in very general terms and illustrated by only some specific examples. This difference may result in broader—although perhaps less certain—protection under the E.E.C. Treaty.

(3) National treatment in regard to the establishment of an American enterprise in France may be claimed under the Convention with France only where it is provided for specifically. National treatment under the E.E.C. Treaty may be claimed not only in

⁴¹ Arts. 52-58.

⁴² *E.g.*, arts. 53 and 58.

⁴³ See Stein, *The New Institutions*, Chapter II *supra*.

areas where it is guaranteed by the relevant right-of-establishment provisions, but also, subject to special provisions, within the area of application of the entire Treaty. The first paragraph of Article 7 of the E.E.C. Treaty provides:

Within the field of application of this Treaty and without prejudice to the special provisions mentioned therein, any discrimination on the grounds of nationality shall hereby be prohibited.

(4) Rights arising under the Convention with France may be vindicated in domestic French courts or, by the United States government, in the International Court of Justice. Rights arising under the E.E.C. Treaty may be vindicated in domestic courts of the Member States or, in some circumstances, in the Community Court of Justice.⁴⁴ In addition, a supranational administrative agency—the Commission—is obligated to supervise the application of the provisions of the Treaty⁴⁵ and to bring Member States who persist in violating a Treaty obligation before the Community Court of Justice.⁴⁶

(5) The Convention with France will have an initial term of ten years and is subject to termination thereafter on one year's notice. The E.E.C. Treaty is of unlimited duration⁴⁷ and makes no provision for termination. It may even be questionable that the Member States have a legal right of unilateral withdrawal from the Community, however unlikely an armed struggle to preserve the union might be.

The provisions of the E.E.C. Treaty which are comparable to those, discussed in detail above, of the Convention with France are with a few exceptions contained in Articles 52–58 of the Treaty. These provisions will first be considered separately; they and their counterparts in the Convention with France will be compared in a concluding section.

B. THE COMPARABLE PROVISIONS OF THE E.E.C. TREATY

Articles 52–58 concern the right of establishment of Community country nationals and companies in countries other than their own; the basic purpose of these provisions is to remove legal discrimination in each of the Six against economic activities of nationals of Member States, other than wage-earning activities.

⁴⁴ See Stein and Hay, Chapter VII *supra*, *New Legal Remedies of Enterprises: A Survey*.

⁴⁵ Art. 155.

⁴⁶ Art. 169.

⁴⁷ Art. 240.

I. THE COMPANIES PROTECTED

Article 58, defining the companies protected, provides in part:

Companies constituted in accordance with the law of a Member State and having their registered office, central management or principal establishment within the Community . . . shall be assimilated to physical persons being nationals of Member States. . . .

The essential element is that the company be constituted in accordance with the laws of a Member State. In addition, *one* of three additional requirements must be met: (1) its registered office, (2) its central management, or (3) its principal establishment must be located within the Community.

Another international agreement in this area of law is helpful in understanding the significance of this rule. All of the Common Market countries, along with some others, were parties to the negotiations relative to the Convention Concerning the Recognition of the Juridical Personality of Foreign Companies, Associations and Foundations elaborated at the Hague in 1951.⁴⁸ Moreover, it could be argued that Article 220 of the E.E.C. Treaty implicitly recognizes the existence of this Convention in providing for negotiations to ensure mutual recognition of companies "in so far as necessary." If the Convention is signed and ratified by all Member States, such negotiations will be unnecessary (Germany, Italy, and Luxembourg have not signed, and Belgium, France, and the Netherlands have signed but not ratified).

Article 1 of the Hague Recognition Convention provides in part:

The juridical personality acquired by a company . . . by virtue of the law of the Contracting States where formalities of registration or publicity have been fulfilled and where the registered office (*siège statutaire*) is located, will be recognized as a matter of right (*de plein droit*), provided that it has, in addition to the capacity to sue and be sued (*ester en justice*), at least the capacity to own property and to make contracts [and] to perform other juridical acts.

Article 2 adds:

Nonetheless, the personality, acquired in conformity with the provisions of Article 1, may be denied recognition

⁴⁸ See Dölle, *Die 7. Haager Konferenz*, 17 ZEITSCHRIFT FÜR AUSLÄNDISCHES UND INTERNATIONALES PRIVATRECHT 161, 185 ff. (1952). This Convention is hereinafter referred to as the "Hague Recognition Convention."

(*pourra ne pas être reconnue*) in another contracting state whose law takes the true central office (*siège réel*) into consideration, if the true central office is deemed to be located on its territory. . . .

The company . . . is deemed to have its true central office at the place where its central administration (*administration centrale*) is established. . . .

For the immediate purposes of this discussion, the provisions of the Hague Recognition Convention are significant in three respects: (1) they recognize the possibility of a geographical divorce between the registered office (*siège statutaire*) and the true central office (*siège réel*); (2) they make clear that *siège statutaire* (the term used in Article 58 of the E.E.C. Treaty) means "registered office"; and (3) they define "true central office" (*siège réel*) as the place where the central administration (*administration centrale*—another term which Article 58 uses) is located.

Since all Six took part in the Hague Recognition Convention negotiations, the terms used presumably mean the same in both instruments. If they do, two questions about Article 58 arise.

1) *Will Companies with only a Registered Office Within the Community Qualify Under Article 58?* Article 58 seems to make possible the creation by third-country nationals or companies (and this, of course, means nationals and companies of Eastern as well as Western countries) of Community companies which will qualify under Article 58 although they have no substantial material connection with the Community; that is, it seems to recognize as beneficiaries of the right-of-establishment provisions companies which are formed under the law of a Member State even though they have only a registered office within the Community. This prospect is so distasteful that one commentator has suggested that Article 58 should be understood to create three rather than two requirements for a qualifying company: (1) it must be formed according to the laws of a Member State; and (2) it must have its registered office (*siège statutaire*) in the Community; and (3) it must have either its central management (*administration centrale*) or its central establishment (*principal établissement*) within the Community.⁴⁹ (Central establishment means, presumably, and among other things, the main store of a retail business or the main plant of a manufacturing concern.)

⁴⁹ Audinet, *The Right of Establishment in the European Economic Community*, 1959 JOURNAL DU DROIT INTERNATIONAL (No. 4, Oct.-Nov.-Dec.) 983, 1017.

Another commentator, Mr. Hubert Ehring, a legal counsellor of the E.E.C. Commission, pointing to the fact that Article 52 provides for abolition of the restrictions on the establishment of agencies, branches, or subsidiaries by nationals of any Member State "*established in the territory of any Member State*," argues:

A company which has only its registered office within the territory of a Member State, while its administration and plants are located within the territory of a third country, is no less to be considered a part of the economy of this third country than is an enterprise situated in that third country whose owner is a national of a Member State (*dessen Inhaber eine die Staatsangehörigkeit eines Mitgliedstaates besitzende natürliche Person ist*), and, [such a company] should therefore be treated in the same way.⁵⁰

Mr. Ehring therefore concludes that companies must also be *established* in a Member State. He suggests further that this requirement is fulfilled "when the central management of a company, but not when its registered office alone, is located in a Member State."⁵¹

Other commentators, although they accept the necessity that companies be *established* in the Community, interpret "establishment" somewhat differently. In their view a company need have neither its central administration nor its central establishment in the Community, provided a substantial part of its business is carried on in the Common Market and that it therefore has meaningful connections with the Community.⁵²

2) *May One of the Six Become the "Delaware" of the Community?* The first requirement of Article 58 is that a company be constituted under the law of one of the Member States. A first question in determining whether a "Delaware" of the Community is a possibility is, therefore: What is a validly constituted company under the company laws of each of the Six? More specifically, the question is whether or not the domestic company laws of each Community country require that the true central office of companies constituted thereunder be situated within its territory.

This is not, apparently, a requirement of Dutch law,⁵³ and Section 5 of the German Stock Company Law provides:

⁵⁰ Ehring, *Das Niederlassungsrecht*, in Groeben, Boeckh, KOMMENTAR ZUM EWG-VERTRAG (hereinafter cited as KOMMENTAR) 183. (Translation by this author.)

⁵¹ *Ibid.* (Translation by this author.)

⁵² WOHLFARTH, EVERLING, GLAESNER, SPRUNG, *DIE EUROPÄISCHE WIRTSCHAFTSGEMEINSCHAFT* 189 (1960) (hereinafter cited as WOHLFARTH, *DIE EWG*).

⁵³ See KOLLEWIJN, *AMERICAN-DUTCH PRIVATE INTERNATIONAL LAW*, No. 3 *Bilateral Studies in Private International Law* 16 (1955); and, generally, Conard, ch. VIII, text at note 121 *supra*.

The place where the company has an office is as a rule to be designated as the seat, or the place from which the business is directed or the place where the central management is carried on.⁵⁴

This at least makes clear that the seat⁵⁵ need not be at the place where the central management (and therefore the true central office) is located,⁵⁶ although it also indicates that there must "as a rule" be at least an office at the place designated by the charter as the seat. From Section 5 it seems possible to conclude that the Stock Company Law of Germany in itself does not require that the true central office or main establishment be located in Germany.⁵⁷

The company laws of the other four Member States do not define seat as explicitly as Section 5 of the German Stock Company Law, and, although each of the laws requires the designation and registration of a seat located within the country, none of them in itself requires a domestic location for the true central office of a company constituted pursuant to it.

The conflict rule which determines the law governing companies in four of the Six does, however, impose such a requirement; according to this rule, the law governing the status of a company is the law of the place where the true central office is located. If, for example, the Belgian subsidiary has its true central office in France, its juridical personality will not be recognized by either country, if it has not complied with the law (French) which each recognizes as governing its status.

The Netherlands again provides the one clear exception, and the rule in Germany is apparently not settled. The majority of the German authorities appear to favor the rule which looks to the location of the true central office.⁵⁸ On the other hand, others maintain that Germany determines the status of German companies which have only a registered office in Germany in accordance with German law.⁵⁹

⁵⁴ "Als der Sitz der Aktiengesellschaft ist in der Regel der Ort, wo die Gesellschaft einen Betrieb hat, oder der Ort zu bestimmen, wo sich die Geschäftsleitung befindet oder die Verwaltung geführt wird." (Translation by this author.)

⁵⁵ "Seat" is here used as the neutral term to avoid use of "registered office" or "true central office." The German equivalent of "seat" is *Sitz*, of registered office *satzungsmässiger Sitz*, and of true central office *effektiver* or *tatsächlicher Sitz*.

⁵⁶ See generally BEITZKE, JURISTISCHE PERSONEN IM INTERNATIONALEN PRIVATRECHT UND FREMDENRECHT 104 ff. (1938).

⁵⁷ The German Limited Liability Company Law has no provision comparable to Section 5.

⁵⁸ See, e.g., Schilling, Note 47 of *Allgemeine Einleitung* in HACHENBURG, KOMMENTAR ZUM GESETZ BETREFFEND DIE G.M.B.H. (1956) at 92.

⁵⁹ Schmidt, Note 7 to Section 5, in GROSSKOMMENTAR, AKTIENGESETZ (1957) at 40: ". . . the *Sitztheorie* can be deemed correct, if it is satisfied by a nominal, statutory seat,

A second question in determining whether a Common Market "Delaware" is a possibility is, then, this: Does Article 58 directly affect the conflict rules of the Six?

Article 58 requires only that companies qualifying under it shall be treated as Community nationals for defined purposes. Nothing is said in Article 58, or elsewhere in the right-of-establishment chapter, about the recognition of the juridical personality of companies. On the other hand, it seems clear enough that Article 58 would be partially meaningless if the Member States were not obligated to recognize the juridical personality of the companies qualifying under it.⁶⁰

If, however, Article 58 has created a rule which derogates from conflict rules of some of the Six,⁶¹ another problem arises. So understood, Article 58 would seem to render meaningless the part of Article 220 of the Treaty which provides:

Member States shall, in so far as necessary, engage in negotiations with each other with a view to ensuring for the benefit of their nationals: . . . the mutual recognition of companies within the meaning of Article 58, second paragraph. . . .

No such negotiations would be necessary if Article 58 of itself requires recognition of the juridical personality of the companies qualifying under it.

It follows that Article 58 probably should not be understood to affect of itself the conflict rules of the Six which are not consonant with it. On the other hand, Article 58 in tandem with Article 220 obligates the Member States to negotiate with each other to conform these rules with Article 58—in order to ensure, for example, that the juridical personality of a company formed in Belgium, with only a registered office there and with its true central office somewhere in the Community (in France, for example) will be recognized in the other five Member States. Moreover, these negotiations, if their timing is not to negate in part the force of Article 58, must take account of the timing of directives to be issued and of the

that is a fictitious seat, and does not require an 'effective domestic seat.'" (Translation by this author.) See also BEITZKE, *op. cit. supra* note 56, at 104A.

⁶⁰ Cf. Loussouarn, *Droit International du Commerce*, 1959 REVUE TRIMESTRIELLE DU DROIT COMMERCIAL (No. 1, Jan.-Mar.) 246, at 251-52.

⁶¹ See Thibierge, *Le Statut des Sociétés Étrangères*, in LE STATUT DE L'ÉTRANGER ET LE MARCHÉ COMMUN (57^e Congrès des Notaires de France, 1959) at 334 ff.; and Loussouarn, *op. cit. supra* note 60, at 250-51.

general program to be established by the Council for the removal of restrictions on freedom of establishment (Article 54).

Timely ratification by the Six of the Hague Recognition Convention plus one additional agreement among the Six would meet these obligations. Article 1 of the Convention provides that the juridical personality acquired by a company by virtue of the law of a signatory state where, *inter alia*, its registered office (*siège statutaire*) is located shall be recognized by the other signatory states (subject to other conditions not here relevant). Article 2 provides, however, that a signatory state *may* (*pourra*) refuse such recognition if the true central office (*siège réel*) is located within its territory (or that of another state) and if it (or the other state) "takes the true central office into consideration."

Since the provisions of Article 2 are not compulsory, the Member States could, after ratifying the Convention, agree among themselves that they would recognize the juridical personality of any company constituted according to the laws of any of the others and having its registered office there, provided it is deemed to be "established" in the Community within the meaning of Article 52.⁶² This would be in keeping with the Convention and would fulfill the obligations arising from Articles 58 and 220. At the same time it would avoid the possibility that companies with no material connection with the Community could claim to be beneficiaries of the right-of-establishment provisions of the Treaty.

Some commentators have denied, expressly or implicitly, that recognition of the companies referred to in Article 58 depends on negotiations pursuant to Article 220.⁶³ None of them has, however, suggested a reason for the reference in Article 220 to negotiations to ensure "the mutual recognition of companies within the meaning of Article 58, second paragraph" if their view is adopted.

Regardless of the view that finally prevails, the result should ultimately be that companies in the Six will enjoy more flexibility of organization than has heretofore been possible. It would be a mistake, however, to conclude that a "Delaware" of the Community—in the American sense—may develop. The idea that it is impermissible to form a company in one country to avoid more onerous laws in another is too firmly embedded in the legal thought of the Six to be discarded.⁶⁴ If, however, there are business reasons for form-

⁶² See text *supra* at notes 51 and 52.

⁶³ See, e.g., WOHLFARTH, *DIE EWG* at 190; Thibièrege, *op. cit. supra* note 61, at 333-337.

⁶⁴ See, e.g., Dölle, *op. cit. supra* note 48, at 188; and WOHLFARTH, *DIE EWG* at 188.

ing a company under Belgian law, for example, although it is to have its true central office in France, the Treaty should ultimately make it possible to do so, despite conflict rules which have heretofore made such an organizational plan perilous.

These conclusions relating to Article 58 seem possible:

1) No company can be a beneficiary of the right-of-establishment provisions if it has no substantial connection with a Community country; "shell" subsidiaries of third-country companies will not be deemed qualifying under Article 58, whatever the reason given for this conclusion.

2) It will ultimately be possible to form a company in one of the Six and locate only its registered office there, provided it is "established" in the Community and provided the avoidance of onerous laws in another of the Six is not the sole reason for such an organizational plan.

3) Article 58 probably has no direct effect on the conflict rules of the Six concerning the recognition of the juridical personality of companies.

4) Articles 58 and 220 obligate the Member States to negotiate with each other to ensure that the juridical personality of the companies qualifying under Article 58 will be recognized throughout the Community. Moreover, the timing of these negotiations will be imposed by the timing of the directives issued and the general program established by the Council pursuant to Article 54.

5) The Hague Recognition Convention, which three of the Six have already signed, offers an ideal vehicle for the fulfillment of these obligations.

2. EMPLOYMENT OF NON-NATIONALS

Freedom of establishment without discrimination based on nationality is to be achieved under the E.E.C. Treaty by, *inter alia*,

. . . applying the progressive abolition of restrictions on freedom of establishment . . . in respect of the conditions governing the entry of personnel of the main establishment into the managerial or supervisory organs of . . . agencies, branches and subsidiaries. . . .⁶⁵

There seems to be general agreement that this provision will require the abolition of foreign merchants' identity cards in France as far as Community nationals and companies are concerned.⁶⁶ The ques-

⁶⁵ Art. 54(f).

⁶⁶ Loussouarn, *op. cit. supra* note 60, at 253; Chaine, *op. cit. supra* note 18, at 237;

tion, then, is what effect this result will have on the employment of non-French personnel by a French branch of the Belgian subsidiary.

It will plainly mean, first of all, that employees of the French branch can work in France without the foreign merchant's identity card heretofore required, if they are Community (for example, Belgian) nationals. What, however, of an American national who has been employed in the Belgian subsidiary? Can he be appointed manager of the French branch and act in this capacity without an identity card? Although the answer to this question must await decision by the competent authorities, three factors suggest that it will be an affirmative one.

One is the fact that Article 54(f) speaks only of "personnel of the main establishment"—there is no limitation in regard to nationality. More convincing, however, is the second factor. This is the fact that, although the foreign nationality of the manager (*gérant*) of the branch of a foreign corporation is not irrelevant (if he is French, he will not be required to obtain an identity card), it is nonetheless the foreign status of the company at which these regulations are directed (if the branch manager is French, the identity card must still be obtained, but it is issued to the directors of the foreign company rather than the branch manager).⁶⁷ Under the right-of-establishment chapter of the Treaty, however, France will be prevented from taking the foreign status of a Belgian company into account. Finally, it should be noted that "merchant" (*commerçant*) is a legal term of art, and that a branch manager is not, as that term is defined, in fact a "merchant."^{67a}

Article 48, paragraph 2 should also force elimination of the labor permit (*carte de travail*) heretofore required of Community nationals (in others of the Six as well as in France). Since, however, the authorization to remain in France (*carte de séjour*) is a public safety measure, the requirement of this authorization is probably permitted by Article 56.⁶⁸

3. OWNERSHIP OF REAL PROPERTY

Measures are to be taken under the Treaty ". . . enabling a national of one Member State to acquire and exploit real property

Thièbierge, *op. cit. supra* note 61, at 339. *Rapport du Conseil Économique sur le Droit d'Établissement dans le Marché Commun* (Dec. 9, 1958) [Jan. 3, 1958] J.O. at 1009.

⁶⁷ Thièbierge, *op. cit. supra* note 61, at 291-92.

^{67a} See Chaine, *op. cit. supra* note 18, at 183.

⁶⁸ Cf. Deletré, *Le Statut Civil de l'Étranger en France*, in *LE STATUT DE L'ÉTRANGER ET LE MARCHÉ COMMUN*, 74 at 154. But see, Savatier, *Le Marché Commun au regard*

situated in the territory of another Member State. . . ."⁶⁹ These measures will not guarantee to Community nationals the right which French nationals enjoy to renew commercial leases (*propriété commerciale*), but they will enjoy such a right by virtue of the general definition of freedom of establishment contained in Article 52, paragraph 2 (and of the relevant provisions of French law).⁷⁰

4. ACCESS TO THE COURTS

Under Article 52, paragraph 2, one of the essential conditions of freedom of establishment is plainly the right to judicial protection.⁷¹ Indeed, Article 52 will force France to exempt Community nationals and companies qualifying under Article 58 from the requirement that foreign plaintiffs post bonds (*donner caution*) to guarantee payment of costs and damages.⁷² This requirement clearly constitutes a discrimination based on nationality.

5. VOLUNTARY TERMINATION OF BUSINESS ACTIVITY

The right-of-establishment chapter says nothing about the right of the owners of an enterprise to cease operations, sell its assets, and leave the country with the proceeds, although this right has been termed a necessary part of the freedom of establishment.⁷³ The most important aspect of this problem is almost certainly the ability to transfer assets. If the Belgian subsidiary liquidates its French branch, for example, will it be able to transfer the resultant assets from France to Belgium? This depends on French exchange controls. As Mr. Jeantet has indicated, assets could be freely transferred to Belgium under present French exchange regulations. Two questions therefore arise: (1) does the Treaty limit France's power to institute new controls in regard to the other Member States; and (2) if France instituted new controls, could they, without violating the Treaty, discriminate against companies like the Belgian subsidiary because control is in the hands of non-Community nationals or companies?

du droit international privé, 48 REVUE CRITIQUE DU DROIT INTERNATIONAL PRIVÉ 237, at 245 (1959).

⁶⁹ Art. 54(e).

⁷⁰ See text at note 26 *supra*.

⁷¹ See also Treaty, art. 220 (last clause) concerning the recognition of judicial and arbitral awards.

⁷² See Deletré, *op. cit. supra* note 68, at 155.

⁷³ Zaneletti, *Le Droit d'Établissement des activités industrielles dans le cadre de la Communauté Économique Européenne*, in [1959] *Les Problèmes de l'Europe* 57.

a. *The Impact of the Treaty on Exchange Controls*

Article 52 guarantees national treatment in regard to the freedom of establishment "subject to the provisions of the Chapter relating to capital." This reservation does not mean, however, that capital movement restrictions may be used to circumvent the right-of-establishment provisions.⁷⁴ Exchange controls may be continued or instituted only for the purposes stated in the chapter relating to capital. Moreover, the Community countries, pursuant to directives of the Council,⁷⁵ will be obligated to eliminate exchange controls "to the extent necessary for the proper functioning of the common market."⁷⁶

These two rules regarding exchange controls mean that such controls may not be used to give competitive advantage, for example, to French enterprises or, more relevantly here, to keep enterprises in France which wish to leave.⁷⁷ The Common Market will only function properly if laws and regulations are eliminated which prevent choices based solely on the free play of economic forces, and freedom of establishment will plainly be less meaningful if the right to withdraw is artificially restricted.

But France is authorized to take measures if divergencies between her exchange regulations in regard to non-member countries and those of other Member States prompt persons residing in a Member State to use transfer facilities within the Community to circumvent French controls.⁷⁸ Moreover, if France's capital market experiences difficulties she may, on the Commission's authorization⁷⁹ or, in urgent cases, on her own initiative,⁸⁰ take protective measures.⁸¹

b. *Discrimination Against Community Companies
Controlled from Abroad*

If France should invoke either of these emergency provisions, could she discriminate against companies like the Belgian subsidiary

⁷⁴ See WOHLFARTH, *DIE EWG*, at 175.

⁷⁵ Art. 69.

⁷⁶ Art. 67(1).

⁷⁷ See Everling, *Einzelheiten der Regelung der selbständigen beruflichen Tätigkeit im Gemeinsamen Markt*, 13 *DER BETRIEBS-BERATER* 857 at 861 (1958).

⁷⁸ Art. 70(2).

⁷⁹ Art. 73(2).

⁸⁰ *Ibid.*

⁸¹ Measures taken on her own initiative will, however, be subject to modification or elimination if the Commission so decides.

because they are under the control of non-Community companies? A prior question—and it probably moots the one stated—is this: *Would France so discriminate?* Since exchange controls in France are based on residence, such discrimination seems unlikely. Attempted discrimination would nowhere find justification in the Treaty, in any case, since nothing in the two emergency provisions described would authorize France to discriminate against the Belgian subsidiary in favor of other residents of Belgium.

c. Conclusion

The importance of these questions lies in the possibility that France might attempt to re-institute more stringent exchange controls in regard to non-member countries than the Treaty permits in regard to Member States. Should this happen, the Belgian subsidiary would be in the same position as other Belgian residents, which is to say, it would be in a better position to withdraw assets from France than would its American parent. But this does not mean that the assets could in turn be transferred from the Belgian subsidiary to the American parent, nor is it any indication that such assets could ultimately be converted into dollars. In sum, the Belgian subsidiary might, by virtue of the Treaty, be able to obtain the proceeds of the liquidation of its French branch and to use them elsewhere in the Community in situations where it would be unable to remit to United States stockholders.

The significance of Mr. Jeantet's conclusion—that exchange controls will become a Community, rather than a national, problem—is evident.

6. EXPROPRIATION

The Treaty makes no express mention of expropriation. Four general provisions are relevant, however. Article 222 provides: "This Treaty shall in no way prejudice the system existing in Member States in respect of property." This means that the Treaty in no way affects the power of the Member States to expropriate private property for public use.⁸² But Article 90(1) subjects "public enterprises and enterprises to which the Member States grant special or exclusive rights" to the rules of the Treaty. In particular it subjects them to Article 7 (prohibiting discrimination based on nationality) and Articles 85–94 (the "antitrust" provisions of the

⁸² See Thiesing in KOMMENTAR, *op. cit. supra* note 50, at 64.

Treaty).⁸³ Moreover, Article 37 requires the Member States to adjust progressively "any State monopolies of a commercial character in such a manner as will ensure the exclusion, at the date of the expiry of the transitional period, of all discrimination between the nationals of Member States in regard to conditions of supply or marketing of goods." This suggests that, while the expropriating power is unaffected, the ends to which nationalization, for example, can be put have in fact been limited by the Treaty, since state monopolies will not be able to pursue either protectionist or anti-competitive goals.⁸⁴ Finally, Article 52 requires that all Community nationals and companies who owned expropriated property be compensated on the same terms that nationals of the expropriating Member State⁸⁵ are compensated.

C. THE CONVENTION WITH FRANCE AND THE E.E.C. TREATY COMPARED IN DETAIL

I. THE COMPANIES PROTECTED

Both the Convention with France and the E.E.C. Treaty require—expressly or in effect—that the law of the place of constitution (and thus of the location of the registered office) should ultimately be determinative of the nationality of companies. Both will require recognition by a signatory of the juridical personality of companies constituted under the laws of another signatory (and therefore having a registered office there), but the E.E.C. Treaty should be interpreted to add one condition: the company must also be "established" in the Community in keeping with Article 52.

This added condition is significant for it will represent a first shift in the law of Community countries concerning companies from a national to a regional perspective; the condition does *not* require "establishment" in the country where the company is formed but *anywhere in the Community*. This is to say that the Treaty has taken a step—however limited—towards the recognition of a *Community* company. In this regard the contrast between the Convention with France and the E.E.C. Treaty is marked.

The criteria determining the companies protected by the E.E.C. Treaty offer, then, a specific instance of the general basic difference

⁸³ But see art. 90(2).

⁸⁴ *Ibid.* See WOHLFARTH, *DIE EWG* at 103.

⁸⁵ If Article 52 is not applicable, then Article 7 will be and the same result should follow.

between the Treaty and the Convention with France. The perspective of the Convention is that of sovereign states which want close economic ties with each other; that of the E.E.C. Treaty, one of sovereign states which want *ever* closer economic ties with each other and ultimately economic unification.

2. THE EMPLOYMENT OF NON-NATIONALS

The E.E.C. countries will ultimately be forced to eliminate, as far as Community nationals and companies are concerned, requirements that foreign nationals and companies be authorized to do business within their territories if no such authorization is required of their own nationals and companies. After these requirements have been eliminated, Community nationals will be able to work in France without a foreign merchant's identity card in situations for which it was heretofore required. Such freedom could extend even to non-Community nationals employed by Community companies.

The Convention with France, on the other hand, does not absolve an American national from obtaining such an identity card, although it does afford protection against its arbitrary refusal.

3. OWNERSHIP OF REAL PROPERTY

Both the Convention with France and the E.E.C. Treaty will guarantee the right of nationals and companies of the, or of any, other signatory to own real property; and both will result, for example, in giving them a right in France to renew commercial leases and, if this renewal right is denied, to demand eviction indemnification.

The two agreements differ in one respect in this area, however, and this is again a specific instance of a general difference between them. The E.E.C. Treaty creates a general right of establishment of which the right to own property is, as Article 54(3)(e) indicates, an element; the Convention creates no general right of establishment but provides for a number of specific rights of which the right to own real property is one. Had no right to own real property been mentioned in the Convention, none would exist under it. Had the Treaty made no specific mention of this right of ownership, the general right of establishment could still be found to imply it. This general difference between the two approaches is important in determining the scope of each.

4. ACCESS TO COURTS

Nationals and companies of the signatories have a right to sue in the courts of the, or of any, other signatory under the Convention with France and the E.E.C. Treaty, respectively. But the E.E.C. Treaty goes further and will, for example, prevent France from requiring Community nationals and companies to post bond to guarantee the payment of costs and damages in actions they initiate.

5. VOLUNTARY TERMINATION OF BUSINESS ACTIVITY

A comparison of the Convention with France and the E.E.C. Treaty in this area is particularly speculative. Both will guarantee certain rights in connection with the withdrawal by a company (of one signatory nation) of its economic activity from the territory of another, but the most significant question—whether the repatriation of assets to the country of origin can be prevented—will be determined in both cases in accordance with as yet undefined criteria. The Convention does, however, give some guarantee that earnings may be repatriated, and both the Convention and the Treaty put some limitation on the freedom of the signatory countries to institute new exchange controls preventing the repatriation of capital assets.

The important difference between the two lies, however, again in their differing basic aims. As economic integration, at which the E.E.C. Treaty aims, proceeds, the feasibility of national exchange controls, which would prevent repatriation from one Community country to another, will diminish. A comparable result, where the United States and France are concerned, will only be achieved through agreements other than the Convention.

6. EXPROPRIATION

Both the Convention and the Treaty guarantee national treatment by the signatories to nationals and companies of the, or of any, other signatory in cases of expropriation. The Convention adds additional requirements—compensation must be the equivalent of the property taken, in effectively realizable form, granted without needless delay, and every effort must be made to accord an opportunity to repatriate the proceeds. The Treaty, on the other hand, specifies some of the conditions under which expropriated enterprises may be operated—and the limitations it imposes may reduce

the possible desirability of expropriation from the point of view of member governments.

IV. THE TREATIES OF COMMERCE AND THE E.E.C. TREATY RELATED

Although the generally applicable criterion in the Italian, German, and Dutch F.C.N. Treaties and in the Convention with France is national treatment, the most-favored-nation clause is also sometimes applicable. All four, for example, guarantee most-favored-nation as well as national treatment in regard to exchange transfers,⁸⁶ and all, except the Convention with France, refer *inter alia* to most-favored-nation treatment in connection with the organization and operation of companies.⁸⁷

A. THE EFFECT OF MOST-FAVORED-NATION CLAUSES

The most-favored-nation clauses raise numerous questions. For example, will companies "residing" in the United States be able to claim the same rights to repatriate assets from France which Community companies "residing" in Luxembourg will have by virtue of the E.E.C. Treaty provisions concerning capital movements? Or, for a second example, will a Delaware corporation be able to assert a right to national treatment in bidding on construction contracts of the German government because Luxembourg companies will have such a right under the services provisions of the E.E.C. Treaty?⁸⁸

Plainly these and similar questions must first be considered in the light of the wording of all relevant provisions of the applicable treaty of commerce. Paragraph 13 of the Protocol to the Convention with France, which permits differing treatment of different currencies, might resolve the example question concerning repatriation of assets from France. And Article XVII, paragraph 2 of the German F.C.N. Treaty requiring "fair and equitable treatment as compared with that accorded to the . . . companies . . . of any third country, with respect to . . . the awarding of . . . government contracts . . ." presumably absolves Germany of a duty to accord

⁸⁶ Italian F.C.N. Treaty, art. XVII, paras. 2, 3; German F.C.N. Treaty, art. XII, para. 1; Dutch F.C.N. Treaty, art. XII, para. 1; Convention with France, art. X, para. 1.

⁸⁷ Italian F.C.N. Treaty, art. III, para. 1; German F.C.N. Treaty, art. VII, para. 1; Dutch F.C.N. Treaty, art. VII, para. 4.

⁸⁸ Arts 59-66. See Part V of this chapter *infra*.

Delaware companies most-favored-nation (as opposed to "fair and equitable") treatment.

But the general question remains: Where the most-favored-nation clause is applicable in a treaty of commerce between the United States and a Common Market country, can an American company, by virtue thereof, claim the same benefits which that country accords Community companies pursuant to the E.E.C. Treaty?

The answer is clear in the Netherlands—it cannot. Article XXII, paragraph 3 of the Dutch F.C.N. Treaty provides:

The most-favored-nation treatment provisions of the present Treaty shall not apply to advantages accorded by either Party . . . by virtue of a customs union. . . .

Moreover, an exchange of letters makes these additional provisions part of the Treaty:

- (1) [The Netherlands] should continue to be able to participate in European regional arrangements . . . even though the Netherlands may thereunder be obliged to grant some reciprocal advantages to other participating countries which it is unable to grant to non-participating countries; [and]
- (2) Either Party, notwithstanding . . . [the provision concerning termination of this Treaty after 10 years have passed], shall be entitled to suspend the operation of particular most-favored-nation provisions of the Treaty to the extent deemed appropriate to the situation . . . [if future contingencies arise].⁸⁹

The Italian F.C.N. Treaty, on the other hand, provides that the most-favored-nation provisions shall not apply to "advantages accorded by virtue of a customs union of which either . . . Party may . . . become a member."⁹⁰ A comparable provision in the German Treaty is more explicit; it provides that most-favored-nation treatment "in regard to customs duties and quotas on goods" shall not apply to "advantages accorded by either party by virtue of a customs union or free-trade area."⁹¹

⁸⁹ *I.e.*, future contingencies which Article XXII, paragraph 4 does not adequately meet. Since the subject of the paragraph from which this second quotation is taken is the reconciliation of the Treaty with *then-existing European arrangements* (that is, in 1956), and since Article XXII, paragraph 4 refers only to the "treatment of goods" and action required or specifically permitted under the G.A.T.T., there is a question whether suspension of most-favored-nation provisions in connection with "future contingencies" created by the E.E.C. Treaty would be warranted. In the light of the letter as a whole, such a restrictive interpretation seems unlikely, however.

⁹⁰ Art. XXIV, para. 3(b).

⁹¹ Art. XIV, para. 6.

"Advantages accorded by virtue of a customs union"—whether implicitly or explicitly—are restricted to questions of tariffs and quotas. The effect of *other* most-favored-nation provisions of the Italian and German treaties—read in conjunction with the E.E.C. Treaty—remains, therefore, an open question. The authors of the E.E.C. Treaty plainly had this problem in mind in drafting Article 234. Its third paragraph provides that in applying conventions between Member States and third countries the latter

shall take into account the fact that the advantages accorded [in the E.E.C. Treaty] by each of the Member States are an integral part of the establishment of the Community and are, because of this fact, inseparably linked to the creation of common institutions, the attribution of powers to them and the granting of the same advantages by all other Member States.

Obviously the drafters intended by this provision to serve notice that the Member States will not grant like advantages to third countries unless the latter offer the same benefits and accept the same burdens—unless, in short, the latter become members of the Community. The justice of this position may be appealing, but it involves in effect a unilateral interpretation by each Member State of its agreements with third countries for which there is no warrant in international law.⁹²

The position of the United States government in regard to its treaties of commerce with Community countries may be foreshadowed by its response to the letter of the government of the Netherlands which became part of the Dutch F.C.N. Treaty. The answer of the U.S. Ambassador to the Netherlands read in part:

As your Excellencies are aware, the United States Government welcomes progress in the development of European cooperation and integration insofar as arrangements for cooperation and integration contribute to a freer flow of trade, a more efficient use of manpower and materials, and greater unity. In this connection, it may be recalled that the United States Government has given concrete support to such organizations as the European Coal and Steel Community and concurred in the waiver relative thereto granted by the CONTRACTING PARTIES to the General Agreement on Tariffs and Trade, bearing in mind the benefits expected to accrue from arrangements designed to create a dynamic competitive common market within the

⁹² Piot, *La clause de la nation la plus favorisée*, 45 REVUE DU DROIT PRIVÉ INTERNATIONAL I (1952).

Community and to insure sound economic relations between the Community and outside countries. The United States Government is prepared to consider sympathetically in the same spirit other proposals which the Kingdom of the Netherlands might make.

An attempt to assert that the most-favored-nation status of American nationals or companies gives them the Community status created by the E.E.C. Treaty seems, in any case, unlikely to succeed in any Community country.

B. CONCURRENT PROTECTION UNDER DIFFERENT TREATIES

The Common Market subsidiary of an American parent may be in a position to claim concurrent protection under more than one treaty. If the Belgian subsidiary, for example, meets the standards of Article 58, the right-of-establishment provisions of the E.E.C. Treaty are applicable. In addition, it may be able to claim protection under Belgium's bilateral treaties of commerce—for example, the Franco-Belgian Convention of Establishment.⁸³ Finally, because the Convention with France recognizes control of companies as decisive for some purposes, the Convention may also apply.

To take only one example, assume that France expropriates property of the Belgian subsidiary's French branch. Under the E.E.C. Treaty the Belgian subsidiary will be able to claim national treatment in regard to compensation; under the Franco-Belgian Convention of Establishment (Article 6), most-favored-nation treatment; and under the Convention with France also, apparently, the rights it affords in case of expropriation. Paragraph 6 of the Convention's Protocol provides:

The provisions of Article IV, paragraph 3 providing for the payment of compensation [in case of expropriation] shall extend to interests held directly *or indirectly* by nationals and companies . . . [of the United States] in property expropriated within the territories of . . . [France]. (Emphasis added.)

V. DOING BUSINESS WITHIN THE COMMUNITY UNDER THE E.E.C. TREATY

The significance of the E.E.C. Treaty to intra-Community operations of American corporate subsidiaries is obviously not limited

⁸³ Of Oct. 6, 1927 [Nov. 5, 1927] J.O. See especially arts. 5, 6, and 7.

to express protection of the right of establishment. At least three other aspects of the Treaty are important, directly relevant, and generally beyond the scope of other chapters of this book. The first is the "services" provisions of the Treaty (Articles 59-66); the second is the Treaty's provision for assimilation of the laws of the Six; and the third is the pressure which the Treaty will create to ameliorate investment conditions.

A. THE "SERVICES" PROVISIONS

By virtue of Article 66 a company qualifying under Article 58 may also claim the protection of the "services" chapter of the Treaty (Articles 59-66). The rights which will be created pursuant to this chapter will complement those arising under the "right-of-establishment" provisions of the Treaty. The difference between the two lies in the situation of the persons, or what is more relevant to this discussion, the situation of the companies protected.

The "right-of-establishment" provisions envisage protection of persons and companies of one Member State who desire to establish, or who have already established, in another Member State. The "services" provisions look to protection of those of one Member State who wish to do business in another without establishing there. An important segment of the rights of such a person or company are regulated by the Treaty provisions concerning tariffs, quotas, and capital movements. These provisions, standing alone, are clearly inadequate, however, to achieve the freedom of economic activity among Member States sought by the drafters of the Treaty. The "services" provisions were therefore included to effect an ultimate elimination of those restrictions on economic activity in the Community not otherwise affected by the Treaty.

"Services" are, as a result of this "stop-gap" nature of the relevant provisions, negatively defined. Article 60 provides:

[W]ithin the meaning of the present Treaty services are considered to be any performance normally performed for remuneration to the extent that they are not regulated by the provisions concerning free circulation of goods, of capital and of persons. (This author's translation.)

This definition suggests that "services" as used in this chapter means something broader than the term "services" as generally used in the phrase "goods and services." The French, German, and Italian equivalents of "performance" (if not the Dutch) suggest, in fact, that "services" means "any performance pursuant to contract."

The essential freedom to be created by the "services" provisions is indicated by Article 59. That Article provides in pertinent part:

[R]estrictions on free performance of services within the Community shall be progressively eliminated during the transitional period in regard to nationals of Member States established in a country of the Community other than that of the recipient of the service. (This author's translation.)

Although there is nothing in Article 59 to indicate as much, the majority opinion apparently is that the "services" provisions envisage only national treatment. The Economic Council of France has, however, taken another view. In its report of January 3, 1959, it stated:

[T]he restriction created by the second line of Article 52 as far as establishment is concerned, which reduced this liberty to one of non-discrimination in regard to foreign nationals of a Member State, does not exist in regard to services. Moreover the drafters of the Treaty used the term "Community" here and not the term "Member States." The problem is, then, one of eliminating the obstacles to the free performance of services within the territory of the Community. . . .⁹⁴

Despite the Report of the Economic Council of France it will be assumed here that the majority view is correct.

The "services" chapter has three provisions which have no counterparts in the "right-of-establishment" chapter. The first of these, Article 64, provides that Member States are prepared to go further than will be required by directives of the Council in freeing services, if their general economic situations and those in the relevant economic sectors permit them to do so. Article 65 provides that as long as restrictions on free performance of services are not eliminated, each of the Member States will apply them without distinction based on nationality or residence⁹⁵ to all performers of services as defined in Article 59, line 1. And finally Article 60 provides:

Without prejudice to the provisions of the chapter concerning the right of establishment, the performer of serv-

⁹⁴ Rapport du Conseil Économique du 9 déc. 1958, [Jan. 3, 1959] J.O. at 1003. (This author's translation.)

⁹⁵ This provision could mean that France, for example, shall not now distinguish between Frenchmen and Belgians in applying such restrictions. This would be its meaning if the Economic Council has correctly interpreted the meaning of Article 59. If the majority is correct about Article 59, Article 64 means only that France will not discriminate between Belgians and Germans, for example, in applying such restrictions.

ices may, in order to perform them, exercise on a temporary basis his activity in the country where the service is supplied under the same conditions as those which that country imposes on its own nationals. (This author's translation.)

The greater liberality of the "services" chapter, as manifested by these three provisions, is probably explained by the fact that the significance of services in the Community—that is, services within the meaning of the Treaty—is less than that of the economic activity of non-nationals established within each Community country.⁹⁶ More radical changes therefore seemed possible.

One example must serve to suggest the significance of the "services" chapter. Assume that an American corporation which specializes in the manufacture and construction of pre-fabricated housing is contemplating the establishment of a Belgian subsidiary. Assume further that an important element in this decision is its potential ability to construct such housing for public housing projects. Assume, finally, that German laws, for example, which authorize public housing projects generally restrict bidding to German nationals and companies. Should the American corporation assume that such restrictive laws will, pursuant to the Treaty ultimately be eliminated?

The Member States have not been fully agreed that such laws must be eliminated, but the Commission has assumed that they must be.⁹⁷ And the Treaty supports the Commission's stand. The construction of housing, as an example, is clearly a service, and it is obvious that the removal of other restrictions on the free performance of services would be meaningless to a company interested in the construction of public housing if it were not free to bid on government contracts.

B. ASSIMILATION OF THE LAWS OF THE SIX

Various provisions of the Treaty will expressly, or in effect, force unification, harmonization, coordination, or approximation of laws of the Six. The term "assimilation" will hereinafter be used to describe these measures in the aggregate, and it will be used in its primary sense—that is, "to make similar."

⁹⁶ See Ehring, *op. cit. supra* note 50, at 164.

⁹⁷ Cf. the discussion of the Commission's proposal pursuant to Art. 54(1) in, Everling, *Vorschlag der Kommission der Europäischen Wirtschaftsgemeinschaft zur Regelung des Niederlassungsrechtes*, 1960 DER BETRIEBS-BERATER 570.

1. THE ASSIMILATING EFFECT OF
ARTICLES 58, 220, AND 221

Reference has already been made to one group of laws—those concerning the recognition of companies—which will in effect be assimilated pursuant to Articles 58 and 220. But Article 220 also provides that the Member States shall negotiate to assure for their nationals:

. . . the maintenance of juridical personality in case of transfer of the central office (*siège*) from country to country and the possibility of merger of companies formed under different national laws. . . . (Translation by this author.)

Added to this is the provision of Article 221 which guarantees (as of January 1, 1961) national treatment in respect of participation in the capital of companies of other Member States (in the sense of Article 58).

It is, perhaps, somewhat artificial to view these as provisions directed at assimilation. Nonetheless, it is clear that their effect, at least incidentally, will be to make the laws of the Six more similar to one another, and it is helpful to view them in this light, as should become clear.

2. PROVISIONS IN THE "RIGHT-OF-ESTABLISHMENT"
CHAPTER EXPRESSLY REQUIRING ASSIMILATION

Three provisions of the "right-of-establishment" chapter expressly require assimilation of the laws.

a. *Article 56(2)*

Under Article 56(2) the Council is, prior to the end of the transitional period, to adopt directives in order to bring about coordination of:

legislative provisions and administrative rules and regulations which prescribe a special regime for aliens . . . for reasons of public order, security and health. (This author's translation.)

Such directives are to be based on Commission proposals and adopted, after consultation with the Assembly, by unanimous vote. (Coordination of administrative rules and regulations are subject to directives adopted by a qualified majority after the end of the

second stage, however.) Assimilation in this area of law is of obvious importance; public order, security, and health offer ready justification for the negation of virtually any Treaty provision or administrative act of the institutions (for example, it may well be argued that the requirement of a foreign merchant's identity card is necessitated by public order and security).⁹⁸

b. *Article 57(2)*

Article 57(2) requires coordination of legislative provisions and administrative rules and regulations of the Member States concerning access to non-salaried activities and their exercise. A proposal of the Commission and consultation with the Assembly are again necessary, and, with certain stated exceptions, the Council is to adopt the required directives unanimously during the first stage and by qualified majority thereafter.

c. *Article 54(3)(g)*

The provision for assimilation of most direct interest to companies, and the only one to be considered here in some detail, is Article 54(3)(g). It requires the institutions to take action to bring about coordination

to the extent . . . necessary and with a view to making them equivalent, (of) the guarantees demanded in Member States from companies within the meaning of Article 58, second paragraph, for the purpose of protecting the interests both of the members of such companies and of third parties. . . . (This author's translation.)

This provision could have far-reaching consequences. A German professor has even suggested that it may outlaw the provisions of the projected reform of German stock company law.⁹⁹

This is an extreme view of the reach of Article 54(3)(g), but the effects it may have are important enough to consider at least some of them in detail. One way of doing this is to list the parties affected by company laws and to ask which aspects of their relationships with each other are governed by rules designed to protect members and third parties. The interested parties—if the discussion is confined to stock companies—are the stockholders, the corporation, the directors and officers, creditors, other third parties, and

⁹⁸ See Chaine, *op. cit. supra* note 18, at 195.

⁹⁹ Bärmann, *Ist eine Aktienreform überhaupt noch zulässig?* 14 JURISTENZEITUNG 434 (1959).

the state. Obviously the rules governing corporation-stockholder relations and corporation-creditor relations are of primary relevance. But what of the rules governing other relationships? For example, the provisions in American corporation law permitting derivative suits constitute a clear recognition that harm done by directors of the corporation harms the stockholders. Thus, some rules governing the company-director relationship may require coordination pursuant to Article 54(3)(g).

Or, for a more remote example, take the rules determining when corporate existence begins. They most directly affect the company-state relationship, but it seems clear enough that they are also relevant in defining the protection of stockholders and creditors.

The limits of the area of company law which could be coordinated pursuant to Article 54(3)(g) can, then, be very broadly defined. Within these limits, what—to ask a further question—are some of the presently applicable rules of stock company law which should be coordinated in the interest of Community stockholders and creditors? Two examples of differing rules in some of the six countries which are relevant to the competing claims for protection of stockholders and creditors suggest the kind of answer which can be expected to this question.¹⁰⁰

1) *Disregard of Corporate Entity*. Some of the rules concerning the conditions under which stockholders may be held liable for the debts of the stock company differ in the Six. Specifically, these are the situations in which the corporate entity may be disregarded—the veil “pierced.”

Assume, for example, that an American corporation has acquired 80 percent of the stock of a Dutch stock company, the remainder of the shares being in the hands of the American corporation's Dutch partners. Wishing to assign certain markets to the Dutch company and aware of the problems which an agreement to share markets may create under the U.S. antitrust laws if the Dutch company is permitted to hold itself out as a wholly independent entity, the U.S. management adopts the following policy on advice of counsel: Some Western European markets will be left exclusively to the Dutch affiliate (but no agreement to this effect will be adopted);

¹⁰⁰ For discussions of the rules which require assimilation under Article 54(3)(g), and under the Treaty generally see, Loussouarn, *Le droit international du commerce et le Marché Commun*, 12 REVUE TRIMESTRIELLE DU DROIT COMMERCIAL (Oct.-Dec., 1959); Bärmann, *Die Europäischen Gemeinschaften und die Rechtsangleichung*, 14 JURISTENZEITUNG 553 (1959); Strauss, FRAGEN DER RECHTSANGLEICHUNG IM RAHMEN DER EUROPÄISCHEN GEMEINSCHAFTEN (1959).

the affiliate will, however, be treated wherever possible as if it were simply the overseas division of the American corporation, ultimate control being always in the hands of the U.S. company.

Key executives are thereafter transferred temporarily from the United States to the Netherlands with a view to familiarizing Dutch personnel with American mass market business methods; and personnel of the Dutch company pass freely back and forth between the two companies for training purposes. Transactions are not always at arm's length; and, because of the pace general economic growth within the Common Market, the business of the Dutch company has developed more quickly than anticipated and this unexpectedly rapid growth has given the Dutch affiliate an appearance of being under-capitalized.

Having first gotten substantial judgments against the Dutch affiliate which it cannot pay, creditors of the affiliate now attempt to obtain payment from the American corporation in the Netherlands, France, and Germany—in each of which the American corporation has assets and in each of which one plaintiff is domiciled. In each case the plaintiff-creditors argue that the Dutch corporate entity should be ignored and the shareholders held liable.

In the Netherlands the U.S. stockholder would not, in all likelihood, be held liable. Disregard of juridical personality is apparently extremely rare.¹⁰¹ On the other hand, a French court could consider the existence of the affiliate an "abuse of juridical personality" and hold that in France the two companies should be considered as one.¹⁰² Finally, a German court might consider that the juridical personality of the Dutch affiliate should be denied recognition—particularly in view of its capitalization and the complete control exercised by the American company—since

. . . the legal status of the juridical person cannot be recognized to the extent that the uses to which it is put are contrary to the purposes of the legal order.¹⁰³

In sum, disregard of the corporate entity would be unlikely in the Netherlands, probable in France, and possible in Germany.

Assuming that a German or French court might conclude that the juridical personality of the Dutch affiliate should be disregarded under the law of the forum, a conflict question arises. Under the

¹⁰¹ See Conard, Chapter VIII, section II, A, 6, b, *supra*.

¹⁰² See Legeais, *L'Extension de la faillite sociale*, 10 REVUE TRIMESTRIELLE DU DROIT COMMERCIAL 289 (1957).

¹⁰³ 22 Bundesgerichtshof (Zivilsachen) 226, 231 (1956). (Translation by this author.)

general conflict rule of both Germany and France the law of the Netherlands would determine whether a company with its central office (*Sitz, siège*) in the Netherlands should be viewed as a juridical entity. But application of this rule, like that of others, is subject to the proviso that its application must not violate the purpose of a German law or French *ordre public*.¹⁰⁴ A German or French court could, then, conclude that application of the usual rule in the example case would be such a violation; a Belgian court in a like case in fact did so.¹⁰⁵

If we assume a wholly-owned subsidiary of an American corporation, the problem is even more complex. There is no apparent objection, or penalty attached, to the ultimate concentration of all shares in the hands of one shareholder in the Netherlands or in Germany. In France, Belgium, and Luxembourg, on the other hand, ultimate single ownership of all the shares results in dissolution of the company. Some—for example a Belgian commercial court¹⁰⁶—have concluded that dissolution is automatic, and that liquidation is not, therefore, a prerequisite of the personal liability of a sole stockholder. And “strawmen” will provide no insulation against this liability in Belgium, for example. In Italy, single ownership of all the shares will not dissolve the company, but the single shareholder is liable for the debts of the company contracted during the period of single ownership should the company become insolvent.¹⁰⁷

2) *Powers of the Heads of Companies to Bind Them.* A second example of rules of company law of the Six which should be coordinated in keeping with Article 54(3)(g) was suggested by a French notary in a particularly able discussion of the status of foreign corporations in Common Market countries.¹⁰⁸ It concerns the power of the heads of companies to bind the company.

In France there is, according to Mr. Thibièrege, a difference between their powers to bind the stock company—the *société anonyme*—and those to bind the limited liability company—the *société à responsabilité limitée*. Under French stock company laws their powers are defined in the charter, or confirmed by subsequent action or decision. Heads of the stock company obligate the company,

¹⁰⁴ See, e.g., Einführungsgesetz zum Bürgerlichen Gesetzbuch § 30: *Die Anwendung eines ausländischen Gesetzes ist ausgeschlossen, wenn die Anwendung gegen die guten Sitten oder gegen den Zweck eines deutschen Gesetzes verstossen würde.*

¹⁰⁵ Judgment of Jan. 5, 1911, Cour de Cassation, Pasirisie II 68 (1911).

¹⁰⁶ Judgment of Oct. 13, 1951, Tribunal Commercial de Bruxelles, Pasirisie III 65 (1952).

¹⁰⁷ Art. 2362, Cod. Civ.

¹⁰⁸ Thibièrege, *op. cit. supra* note 61 at 344 ff.

therefore, only if they have express authority to do so, unless the action taken concerns usual every-day company transactions which it may be expected all company heads are authorized to carry out. If real estate is to be sold, or money borrowed, however, company heads have only the power expressly conferred on them, and third parties fail to verify this power at their peril.

Under the French limited liability company act, on the other hand, the heads of the company are granted powers by law which third parties may rely on even if the charter limits them. Such limitations will render the company heads liable to the stockholders if they are transgressed, but that is their *only* potential effect. These legal powers are, in short, granted as a matter of public policy.

The rules pertaining to limited liability companies in France were borrowed from the German limited-liability-company law. Under German law, however, the heads of German stock companies also have powers which the law grants as a matter of public policy and which are unalterable by charter.

In Italy company heads have all powers to obligate the company, but limitations on their powers are binding on third parties if they have been recorded in the public register of enterprises or if the company can prove such third persons knew of the restrictions.

Finally, in Belgium the powers of the heads of the limited liability company as well as of those of stock companies can be restricted in the company charter to the detriment of third parties, even parties who have no knowledge of the restrictions.

3. ASSIMILATION UNDER THE TREATY SUMMARIZED

Three instances of assimilation in the Six have here been suggested. Their possible significance is worth consideration at this point.

The three instances were—to re-order them: (1) assimilation of laws to the principle of non-discrimination (Article 221, for example, which eliminates discrimination against the participation of non-nationals in the capital of companies); (2) assimilation with one another of the laws protecting stockholders and creditors (Article 54(3)(g)); and (3) assimilation of the conflict rules determining the nationality of corporations (Articles 58 and 220).

The first of these may be most significant in eliminating *legal* obstacles to Community-wide operations—present governmental discrimination based on nationality will be removed and future discrimination is prohibited. The second may be most important in

eliminating *economic* obstacles stemming from differences of the laws: If creditors can be certain that their protection will be essentially the same regardless of the place of formation of a company within the Community, Community-wide transactions will be facilitated. And if stockholders can be sure of like protection regardless of the laws within the Community under which a company is formed, they may be more willing to approve Community-wide ventures. More important, companies may find it easier to raise capital on a Community rather than country basis.

The third instance of assimilation discussed—that to be effected by Articles 58 and 220—may be most significant as first attack on *psychological* obstacles to Community-wide company operation. Because Article 58 (read with Article 52) looks to location of any two of the three elements (the registered office, the central management, and the central establishment) not in the country where the company is formed but *anywhere* in the Community, it contains an invitation to view the Six as a whole, to substitute a Community for a national perspective.

Such a shift in perspective, if it became general, would be important not only to the Community company which desires to operate on a Community-wide basis. The extent of legislative assimilation in the Six will be determined by the extent to which such a shift occurs. Coordination of the laws is possible now, but the extent of unification would seem to depend on the extent to which a Community consciousness replaces the present sense of allegiance solely to the six nation-states.

4. FURTHER PROPOSALS FOR ASSIMILATION

Three suggestions have already been publicly made which are relevant to the Community-wide operation of companies, which seem feasible, and which may be the next logical steps, departing from Article 58, in the progression towards a Community viewpoint and unification.

The first of these suggested changes is the institution by treaty of a Community companies register.¹⁰⁹ No Common Market company would be required to register but advantages of registration would be substantial. For example, limitations of the powers of company heads would be effective against third parties from the date of their publication in the register—but only then. Moreover, registration could be accompanied by the issuance of a European

¹⁰⁹ *Id.* at 352.

License of Establishment, which would result in simultaneous registration of the company in the commercial registers of each of the Six.

The second suggested change—and this obviously goes considerably further in the direction of a unified Community company law—has been to create a Common Market Securities Exchange Commission.¹¹⁰ The argument is that some such central regulation of the issuance of shares is necessary if investors are to be attracted in any numbers to Community companies established in other countries. An intermediate step in this direction—a uniform prospectus which could effect the listing of stock with all of the exchanges in the Six—has also been discussed by the exchanges.¹¹¹

Professor Tunc, of the Faculty of Law of Paris, in an article on the United States S.E.C. had already recommended in 1952 that French legislators might take inspiration from the various U.S. federal laws controlling corporations and their issuance of shares.¹¹² Something comparable to the S.E.C. has also been urged in Holland, and in Belgium a Banking Commission already exists which plays a role similar to that of the S.E.C.¹¹³

The final suggestion has come—with only minor variations—from a number of sources—a secretary of state of the German Ministry of Justice,¹¹⁴ from the French notary¹¹⁵ already quoted, and from a Dutch professor.¹¹⁶ It has also been the basis of an international congress convened by the Paris bar on June 16, 17, 18, 1960.¹¹⁷ The proposal is that a Common Market stock companies law should be created which organizers could, but need not, choose. Professor Sanders of Holland has suggested as a model the Canadian Dominion Companies Act. The purport of this analogy is indicated by these sentences from Fraser's *HANDBOOK ON CANADIAN COMPANY LAW*:

Each province in Canada has a Companies Act of its own, under which companies may be incorporated, and there is also a Dominion Companies Act under which companies

¹¹⁰ *Id.* at 354.

¹¹¹ See *The Journal of Commerce*, 1:1 (Aug. 2, 1960).

¹¹² Tunc, *Le Contrôle fédéral des sociétés par actions aux États-Unis*, 5 *REVUE TRIMESTRIELLE DU DROIT COMMERCIAL* 255, 509 (1952).

¹¹³ See Conard, Chapter VIII at V, D, 4, *supra*.

¹¹⁴ Strauss, *op. cit. supra* note 100, at 24 ff.

¹¹⁵ Thibierge, *op. cit. supra* note 61.

¹¹⁶ Sanders, *Vers une société anonyme européenne?* 1960 *LE DROIT EUROPÉEN* 9 (No. 16, Jan.).

¹¹⁷ See 1960 *REVUE DU MARCHÉ COMMUN* 172 (No. 25, May).

may be formed with power to carry on business throughout the Dominion. (p. xix)

Dominion companies have a status and powers entitling them to carry on business throughout Canada which no provincial legislature is entitled to destroy. (p. 7)

Both Professor Sanders and Dr. Strauss of the German Ministry of Justice point to the fact that European states have already created by convention a number of international public companies. "Eurofima"—a company formed to finance the renewal of railroad equipment—is one. Moreover Articles 45 and following of the Euratom Treaty set a precedent in providing for Community Joint Enterprises to foster undertakings of outstanding importance to the development of atomic industry. Euratom Joint Enterprises will be constituted by a decision of the Euratom Council.

To the proposals of Professor Sanders and Dr. Strauss, Notary Thibièrge adds the suggestion that a Community Arbitral Tribunal be created. Parties to disputes concerning the treaty law creating Common Market stock companies could refer to this tribunal by agreement. Mr. Thibièrge thereby emphasizes the fact—which the Common Market Treaty recognizes in granting the Court of Justice sovereign jurisdiction in interpretation of the Treaty—that common rules require uniform interpretation.

5. CONCLUSIONS

The three instances of legislative assimilation discussed, when completed by the three proposals alluded to, would form a program of progressive assimilation of laws affecting companies.

Beginning with adherence to the principle of non-discrimination, it adds coordination of the laws protecting shareholders and creditors. The perspective in both instances is the nation-state. Unification of the conflict rule determining company nationality—Articles 58 and 220—is strikingly different in viewpoint: the six countries are seen as an entity.

The proposal to create a Common Market companies register would entail a modest step toward unification involving the creation of a minor supranational agency. The Common Market S.E.C. proposal would, if realized, represent a far more significant piece of international legislation and would create a major supranational administrative agency. Finally, the proposal to create a Community Stock Companies Law by treaty under which companies could, but

need not, be formed would obviously be a highly significant step towards unification.

C. THE PRESSURE TO AMELIORATE INVESTMENT CONDITIONS

It is obviously difficult to isolate the causes for the efforts of the Common Market countries, with the exception of Germany, to attract foreign investment. Some, if not all, would no doubt have been made even if the Common Market had not come into existence.

But the creation of the Common Market has plainly increased the interest of the foreign investor in the Six, and thereby the stakes for which the individual countries are striving. The important point is that such efforts are being made both by the individual countries of the Six¹¹⁸ and by non-member countries, notably Great Britain. The importance of this fact lies in the pressure which it generates to ameliorate investment conditions. The existence of this pressure must be taken into account in assessing the effective significance of the Treaty.

It has been suggested, for example, that restrictions on the right of aliens to exercise non-wage-earning activities will not be eliminated but simply extended to apply to nationals as well. It is also possible to assimilate laws and regulations by adopting the most restrictive standards applied by any of the Six (for example, those concerning access to non-wage-earning activities (Article 57(2))). The desire to attract foreign capital will be an important factor countering the inevitable pressures to move in such directions, and the Treaty will do much to increase it.

¹¹⁸ See Delvaux, *Investissements étrangers et Marché Commun*, 1960 REVUE DU MARCHÉ COMMUN 183, 190-92 (No. 25, May).

Chapter X

The Protection of Competition

*Stefan A. Riesenfeld **

I. INTRODUCTION—SCOPE, BACKGROUND, AND INTERPRETATION OF THE PROVISIONS FOR THE PROTECTION OF COMPETITION IN THE E.E.C. TREATY

A. SCOPE AND ORGANIZATION OF THE PERTINENT ARTICLES

I. PLACE OF THE REGULATIONS WITHIN THE TOTAL STRUCTURE OF THE TREATY

One of the most important and widely publicized aspects of the Treaty Establishing the European Economic Community is its protection of competition in the Common Market. Since the publication of the texts of the respective international agreements,¹ a veritable flood of literature on that subject has emerged in the Community countries as well as abroad, and a host of controversies has arisen over the significance and import of the controlling clauses.²

The pertinent articles differ greatly in structure and are distributed and arranged over various portions of the Treaty, as a

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¹ The Treaty establishing the European Economic Community is one of the group of international agreements signed in Rome on March 25th, 1957. It is supplemented by the Convention relating to certain Institutions common to the European Communities, of the same date, and a number of protocols.

² See the bibliography in part IV, notes 580 and 634 *infra*.

consequence of the fact that the play of the forces of competition in the market may be channelized and affected by different modes and measures of governmental action as well as by arrangements and other practices of private enterprises. However, this dispersal of the regulations and the multitude of interference types envisaged must not becloud the essential unity of purpose and interconnection of the various segments of the total scheme.

The E.E.C. Treaty is divided into six principal parts dealing, consecutively, with the Principles (Articles 1-8), the Bases of the Community (Articles 9-84), the Policy of the Community (Articles 85-130), the Association of Countries and Territories Overseas (Articles 131-136), the Institutions of the Community (Articles 137-246), and, finally, General and Concluding Provisions (Articles 210-248). Articles bearing on the protection of competition are found primarily in the First, Second, and Third parts of the Treaty.

The most comprehensive and specific set of provisions on the subject is placed in Part Three, Title I, Chapter 1 of the Treaty, and bears the telling sub-heading "Rules of Competition." It deals with restrictive practices by private or public enterprises (Articles 85-90), dumping (Article 91), and public subsidies (Article 92). It must not be overlooked, however, that the provisions of this chapter are supplemented by important articles in other parts or chapters of the Treaty.

In the first place, Part One of the Treaty, which establishes the governing principles of and for the Community, specifies, in Article 3, the principal activities of the Community for the accomplishment of its task and lists, in a catalogue of eleven programmatic items, the following two:

- (f) The establishment of a system which safeguards the competition within the Common Market against adulterations; . .
- (h) The harmonization of the provisions of national laws to the extent required for an orderly functioning of the Common Market. . . .

The particular position in the Treaty, as well as the broad phraseology of this provision, makes it clear that one of the basic objectives and tenets of the Common Market is the achievement of a market order which is free from "falsifications" due to discriminatory or otherwise unduly restrictive practices whether imposed by governmental mandate or initiated by private action.³

³ Moreover, it should be noted that the proscription of any discrimination on national

Again, since Part Two regulating the Bases of the Community focuses primarily on the structural pattern of the Common Market as created by the gradual abolition of reciprocal territorial barriers restricting the freedom of inter-market trade, employment or mobility of workers, and movement of capital, only such interference with competition is dealt with in that connection as stems from quantitative restrictions or government monopolies entailing discriminations on a territorial or local basis. The Treaty aims at the ultimate elimination of all quantitative restrictions on imports and exports impinging on inter-market trade; but Article 36 excepts prohibitions against, and restrictions of, the importation, exportation, or transit of goods, justified by reasons of public morals, order, and safety, of the protection of the health and life of persons and animals, of the preservation of plants, of the conservation of natural treasures having an artistic, historical, or archeological value, or of the protection of industrial or commercial property. Nevertheless the Article specifies that such prohibitions and restrictions must "not constitute a means of arbitrary discrimination or a disguised restriction on the commerce among the Member States."

Article 37, similarly, ordains a transformation of existing state trade monopolies in such a fashion that at the end of the transitional period any discrimination among nationals of the Member States is eliminated with respect to conditions governing supply to, or procurement from, such monopolies. This provision is declared to apply to all institutions by which a Member State exercises, in law, or in fact, a direct or indirect control, direction, or discernible influence over importation or exportation among Member States. It also applies to monopolies conferred by a Member State upon other legal entities.

2. THE RULES OF COMPETITION FOR ENTERPRISES IN PARTICULAR

As has been stated before, the core of the Treaty provisions for the protection of competition in the Common Market are con-

grounds is one of the guiding principles of the E.E.C. by virtue of Article 7 of the Treaty which provides:

Any discrimination on the grounds of nationality is prohibited within the field of application of this Treaty, without prejudice to the special provisions contained therein.

The Council, acting with qualified majority upon a proposal of the Commission and after consultation of the Assembly, may publish any regulation for the purpose of prohibiting such discrimination.

tained in Articles 85-90. While the last of these articles deals primarily with public enterprises and enterprises which have been accorded special or exclusive rights, the first five contain rules governing the market conduct of enterprises in general. Since the following discussions deal primarily with their significance and application, the full text of these Articles⁴ is set out for the convenience of the reader:

ARTICLE 85

(1) Incompatible with the Common Market and prohibited are all agreements between enterprises, all decisions of associations of enterprises and all concerted practices which are apt to affect the commerce between Member States and which have as their object or effect the prevention, restriction or adulteration of competition within the Common Market, and especially those which consist in:—

- (a) fixing directly or indirectly the purchase or sales prices or other conditions of transacting business;
- (b) limiting or controlling the production, distribution, technical development or investment;
- (c) dividing the markets or sources of supply;
- (d) applying unequal conditions for equivalent goods or services vis-à-vis other contracting parties, thereby inflicting upon them a competitive disadvantage;
- (e) conditioning the conclusion of contracts upon the acceptance by the other contracting parties of additional goods or services, which, neither by their nature nor by commercial usage, have any connection with the object of these contracts.

(2) The agreements or decisions prohibited according to this article are void.

(3) However, the provisions of paragraph (1) may be declared inapplicable to:

- any agreement or category of agreements between enterprises,
- any decision or category of decisions of associations of enterprises, and
- any concerted practice or category of concerted practices,

which contribute to the improvement of the production or distribution of commodities or to the promotion of

⁴ The wording of the translations is by the author. No satisfactory English translation is in print. The difficulties of an adequate rendition in English of the provisions of the Treaty are formidably enhanced by the fact that there are substantial divergencies between the four controlling texts. See *infra passim*.

technological or economic progress, while reserving an appropriate share of the resulting profit to the consumers and without:

- (a) imposing on the enterprises involved any restrictions not indispensable for the attainment of these objectives, or
- (b) enabling such enterprises to eliminate competition in respect of a substantial portion of the commodities involved.

ARTICLE 86

(1) Incompatible with the Common Market and prohibited is the abusive exploitation of a dominant position in the Common Market or a substantial part thereof by one or several enterprises to the extent that it is capable of affecting the commerce between Member States.

These abusive practices may consist especially in:

- (a) fixing directly or indirectly the purchase or sales prices or other conditions of transacting business;
- (b) limiting or controlling the production, distribution, technical development or investment;
- (c) applying unequal conditions for equivalent goods or services vis-à-vis other contracting parties, thereby inflicting upon them a competitive disadvantage;
- (d) conditioning the conclusion of contracts upon the acceptance by the other contracting parties of additional goods or services which, neither by their nature nor by commercial usage, have any connection with the object of these contracts.

ARTICLE 87

(1) Within a period of three years from the entry into force of this Treaty, the Council, by unanimous vote upon a proposal by the Commission and after consultation of the Assembly, shall issue all appropriate regulations or directives for the purpose of the application of the principles laid down in Articles 85 and 86.

If such provisions have not been adopted within the above-mentioned time limit, they shall be enacted by the Council pursuant to a vote by a qualified majority upon a proposal by the Commission and after consultation of the Assembly.

(2) The provisions specified in paragraph (1) have the purpose, in particular, of:

- (a) assuring the observance of the prohibitions set forth in Articles 85 and 86 through the imposition of punitive or coercive fines;

- (b) determining the particulars governing the application of Article 85, paragraph (3), having regard for the need both of assuring an effective supervision and, at the same time, of simplifying administrative control to the greatest possible extent;
- (c) specifying, if need be, the scope of application of Articles 85 and 86 with respect to the different sectors of the economy;
- (d) defining the respective tasks of the Commission and of the Court of Justice in the application of the provisions envisaged in this paragraph;
- (e) defining the relations between the provisions of national law on the one hand and on the other hand the provisions, contained in this Section or issued pursuant to this Article.

ARTICLE 88

Until the entering into force of the provisions issued in application of Article 87, the authorities of the Member States shall pass on the permissibility of agreements, decisions and concerted actions as well as on the abusive exploitation of a dominant position in the Common Market in conformity with the law of their own countries and with the provisions of Articles 85, especially paragraph (3), and 86.

ARTICLE 89

(1) Article 88 notwithstanding, the Commission, upon assumption of its activities, shall watch over the observance of the principles laid down in Articles 85 and 86. At the request of a Member State or ex officio, and in cooperation with the proper authorities of the Member State obliged to render official assistance, it shall investigate the cases in which contraventions of these principles are suspected. If it finds that there has been a contravention, it shall propose appropriate means for its discontinuance.

(2) If the contravention is not discontinued the Commission shall render a decision to the effect that there has been such a contravention, furnishing reasons for its finding. It may publish the decision and authorize the Member States to take the necessary remedial measures, specifying the conditions and particulars thereof.

ARTICLE 90

(1) The Member States shall not issue or retain in force any measures which contravene this Treaty, and in par-

ticular its Articles 7 and 85-94, with respect to public enterprises to which they accord special or exclusive rights.

(2) Enterprises which are entrusted with the rendition of services of general economic interest or which have the character of a fiscal monopoly are subject to the provisions of this Treaty, especially the rules governing competition, to the extent that the application of these provisions does not prevent, in law or in fact, the performance of the special task imposed on them. The development of trade must not be affected to a degree which is contrary to the interest of the Community.

(3) The Commission supervises the application of this article and, if necessary, addresses the appropriate directives or decisions to the Member States.

B. GENESIS OF THE RULES PROTECTING COMPETITION AND THE PROBLEMS OF THEIR INTERPRETATION

When the governing texts⁵ of the Treaty were published, it became evident to the students of the subject that the chapter on the rules governing competition would create perplexing and far-reaching problems. The doubts and controversies prompted by the phrasing and arrangement of the pertinent articles concerned not only the exact types of restrictive practices falling within the purview of these regulations, but also their relation to the existing laws governing the subject in the Member Countries and their status prior to their implementation as envisaged by the Treaty.

The complexities of proper interpretation are greatly augmented by the fact that the four governing versions of the text vary only too often in significant nuances of style and vocabulary, with the result that the proper construction cannot safely rely on the phrasing of a particular clause in only one language, and that any textual interpretation must always take account of the composite meaning conveyed by the four instruments.

Unfortunately, the task of interpretation finds precious little guidance or assistance in the actual minutes or exposés of the draftsmen, inasmuch as they have not been put into print. To be sure, some commentators have had access to the preparatory materials for the purpose of publishing essential passages.⁶ But not much

⁵ According to Article 248 of the Treaty, the German, French, Italian, and Dutch texts are each equally authentic and equally binding.

⁶ *Le Marché Commun et l'Euratom*, 10 CHRONIQUE DE POLITIQUE ETRANGÈRE 399 (Brussels 1957).

can be gleaned therefrom; moreover, in the case of Articles 85-91, the drafters consciously chose phraseology of a certain vagueness in order to facilitate possible agreement.⁷

Undoubtedly the richest source of interpretive clues among the documents *preceding* the final formulation of the Treaty is the famous Spaak Committee Report⁸ which constituted the tentative blueprint for the Common Market. The idea of such an institution emerged in the wake of the wreck of the plans for a European Defense Community and stemmed from the belief that the economic arena furnished better prospects for European integration than the political sphere. The Council of Europe, the Common Assembly of the European Coal and Steel Community, and the governments of the Benelux countries supported efforts in that direction as early as 1954, and the German government arrayed itself with these forces by a memorandum of 1955. As a result, the Foreign Ministers of the E.C.S.C. countries, meeting in Messina in 1955, agreed upon the activation of such a plan and appointed an intergovernmental committee under the chairmanship of Dr. Spaak, then Belgian Minister for Foreign Affairs, to work out a suitable scheme for the creation of a common market. The labors of the Committee resulted in a report which was published in April 1956 and accepted by the following conference of the Foreign Ministers in Venice as the basis for the final negotiations of the Treaty.⁹

The Report, after commenting briefly on the advantages of a European common market, stated at the outset that the creation of such a market required a "converging action following three main lines of approach," of which one consisted in the establishment of "normal conditions of competition" through elimination of all protective barriers compartmentalizing the European economy and another in the assurance of normal conditions of competition by remedying the effects of state interventions and monopolistic situations.¹⁰

In elaborating on the second point, the Report emphasized that,

⁷ *Id.* at 482, referring to a document drafted by the secretariat of the Intergovernmental Conference.

⁸ Comité Intergouvernemental créé par la Conférence de Messine, Rapport des Chefs de Délégation aux Ministres des Affaires Etrangères [hereinafter cited as Spaak Report] (Brussels, April 21, 1956).

⁹ See the official commentaries in Appendix (Anlage) C to Bundestagsdrucksache 3440, Deutscher Bundestag, 2. Wahlperiode 1953, Verhandlungen des Deutschen Bundestages, 2. Wahlperiode 1953 (1957).

¹⁰ Spaak Report, *supra* note 8, at 15.

in view of the custom of enterprises to form cartels with the ensuing monopolistic practices and possibilities of discrimination and market division, it was necessary to impose rules of competition upon the enterprises in order to prevent virtual dismemberment of the market through discriminatory pricing, dumping, and market divisions. In addition it was necessary to curtail all state intervention undertaken for the purpose of favoring national enterprises (and thus with "the purpose and effect of adulterating competition") rather than in the general interest and for the increase of over-all production. Moreover, for the achievement of a truly competitive market, it was also necessary to ascertain and, so far as feasible, to correct the incidences which flowed from competition from the disparity of state legislation in general.¹¹

It followed that the control of the standards of competition among enterprises, the curtailment or elimination of subsidies and similar measures, and the provision of counter-measures against distortions as well as possible harmonization of state legislation were among the principal actions needed to establish a common market and to make it function.¹²

These rather general observations of the Spaak Report were, later therein, followed by a more detailed outline of the rules of competition in conjunction with an over-all study of "a policy for the common market."¹³

In turning first to the rules applicable to the enterprises, the Report focused on two main problems—that of discrimination and that of monopoly. The authors of this section were fully aware of the fact that these two problems were overlapping and that, in the absence of public measures to that effect, discriminatory treatment of consumers or suppliers is practicable chiefly if the enterprises engaging in such conduct possess monopolistic powers by virtue of size, specialization, or cartelization. An intervention in case of discrimination, therefore, was considered warranted and necessary when a consumer is virtually compelled to submit to the terms of his supplier, or vice-versa, and suffers a competitive disadvantage from discriminatory treatment. In addition, it was urged that monopolistic situations and practices needed curbing if they contravened the fundamental objectives of the common market, as is the case in the event of a division of markets, restriction of produc-

¹¹ *Id.* at 16 and 17.

¹² *Id.* at 23.

¹³ *Id.* at 53.

tion or technological progress, or capture or domination of the market for a product by a single enterprise. It was recognized, however, that purely local practices, which did not affect commerce between the states, did not need to come within the purview of the Treaty. A comparison of the form of the final Treaty, as outlined before, with the Spaak Report demonstrates clearly that the latter exerted a substantial influence on the former and, therefore, is a valuable guide to its interpretation.

In addition to the Spaak Report, guides to a solution of problems of interpretation created by the Treaty may be found in the documents and in the discussions which, though *following* the formulation of its text, formed part of the ratification procedures in the Community countries. Apart from the parliamentary debates in the different countries, an official commentary, appended by the German government to the text of the Treaty in the course of the ratification procedures in the German parliament, deserves attention.¹⁴

In ascertaining the meaning and effect of the Treaty sight should also not be lost of the fact that its provisions relating to restrictive business practices were not the first venture into the field of international regulation of restrictive business practices and that previous efforts and experiences were undoubtedly in the mind of the draftsmen. This applies with particular force to the analogous provisions in the Treaty establishing the European Coal and Steel Community,¹⁵ but may also be true with respect to the chapter on restrictive business practices in the abortive Havana Charter for the proposed International Trade Organisation.¹⁶

Most of all, the views of the draftsmen must have been in-

¹⁴ 1 Schriftenreihe zum Handbuch für Europäische Wirtschaft 223 (Der Gemeinsame Markt) 1957.

¹⁵ Treaty constituting the European Coal and Steel Community (E.C.S.C.), Articles 4, 65, and 66. On the influence of the provisions protecting competition in the E.C.S.C. Treaty on the analogous provisions in the E.E.C. Treaty, see the observations to that effect in the general report by Dr. Hellwig in the Report of the Committee on Economic Policy of the German Bundestag on the draft of the Law Against Restraints of Competition, *Schriftlicher Bericht des Ausschusses für Wirtschaftspolitik* (21. Ausschuss) über den Entwurf eines Gesetzes gegen Wettbewerbsbeschränkungen, Deutscher Bundestag, 2. Wahlperiode, zu Drucksache 3644, 1 at 9, 10 (1957).

¹⁶ Havana Charter for an International Trade Organisation, [1947-48] U.S. Dept. of State, Commercial Policy Series nos. 113-14; U.N. Doc. E/Conf. 2/78 (1948). The Havana Charter dealt in Chapter V with restrictive business practices. Article 46, delineating the general policy towards restrictive business practices, was to apply "whenever . . .

2. (b) the practice is engaged in, or made effective, by one or more private or public commercial enterprises or by any combination, agreement or other arrangement between any such enterprises, and
- (c) such commercial enterprises, individually or collectively, possess effec-

fluenced by the development of legislation against anti-competitive practices in the various Member Countries, especially Germany, France, and the Netherlands. For that reason, as well as because the regulations of the Treaty are superimposed upon the various national measures of this type, individual national legislation will be discussed prior to a detailed study of the scope and effect of the pertinent articles in the Treaty.

II. THE PROTECTION OF COMPETITION UNDER THE NATIONAL LAWS OF THE COMMUNITY MEMBERS

A. GERMANY

I. HISTORICAL ANTECEDENTS OF THE LAW AGAINST RESTRAINTS OF COMPETITION OF 1957

a. *The Period Prior to the Allied Occupation*

(1) *Developments before the passage of the Cartel Ordinance of 1923.* Germany evolved special legislation for the protection of competition and the control of cartels and other restrictive business practices only in the wake of World War I. Prior to that time illegality, if any, of combinations in restraint of trade or monopolistic practices had to be based on the general principles of law, especially those deduced from the German Civil Code.¹⁷

To be sure, prohibitions of certain injurious types of restrictive trade practices go back to the early sixteenth century. But they

tive control of trade among a number of countries in one or more products,"

and defined as such practice the following:

- "3. (a) fixing prices, terms or conditions to be observed in dealing with others in the purchase, sale or lease of any product;
- (b) excluding enterprises from, or allocating or dividing, any territorial market or field of business activity, or allocating customers, or fixing sales quotas or purchase quotas;
- (c) discriminating against particular enterprises;
- (d) limiting production or fixing production quotas;
- (e) preventing by agreement the development or application of technology or invention whether patented or unpatented;
- (f) extending the use of rights under patents, trademarks or copyrights granted by any Member to matters which, according to its laws and regulations, are not within the scope of such grants, or to products or conditions of production, use or sale which are likewise not the subjects of such grants."

¹⁷ For the pre-1923 status of German law concerning restrictive business practices see: ISAY, *DIE GESCHICHTE DER KARTELLGESETZGEBUNGEN* (1955); Kronstein & Leighton,

remained sporadic and ineffective.¹⁸ In the mining industry restrictive and monopolistic practices were actually authorized and encouraged or even imposed by governmental action.¹⁹ The liberalistic ideas and tendencies of the nineteenth century brought about in Germany, as in other countries, the recognition of the two great, though polar, principles of freedom of trade and freedom of contract. The former principle was proclaimed in Germany in a basic code regulating the exercise of trades and professions, the *Gewerbeordnung* of 1869. The rise in Germany of numerous cartel agreements as an aftermath to the economic depression of 1873 brought the import of this legislation for the legality and enforceability of restrictive agreements into sharp focus. In two famous decisions, rendered toward the end of the nineteenth century, the Supreme Court of Germany held that the principle of freedom of trade as laid down in the *Gewerbeordnung* did not bar the self-protection of manufacturers and distributors against ruinous competition.²⁰ It thus opened the gate for the celebrated differentiation between "good" and "bad" cartels, holding agreements of the first type to be valid and judicially enforceable.²¹

World War I and the period of scarcity following it entailed a brief period of economic regulation against excessive price increases which was formally terminated in 1926.²² Moreover, the trends toward the abolition of the old capitalistic market order and the erection of a planned economy that accompanied the collapse of the Imperial Regime produced publicly controlled compulsory cartel organizations in the coal and potassium industries (1919),²³ and subsequently a similar arrangement was introduced in the German match manufacturing industries (1930).²⁴ Any general regulation of the status of cartels, however, had to wait until four years after the War.

(2) *From the Cartel Ordinance of 1923 to the Nazi regime.* In 1923 finally, the government, pressed by public opin-

Cartel Control: A Record of Failure, 55 YALE L. J. 297, 302 (1946); Schwartz, *Anti-trust Legislation and Policy in Germany—A Comparative Study*, 105 U. PA. L. REV. 617, 625 (1957).

¹⁸ See Isay, *op. cit. supra* note 17, at 5 and 81.

¹⁹ *Id.* at 13, 15, and 83.

²⁰ German Supreme Court, June 25, 1890, 28 Entscheidungen des Reichsgerichtes in Zivilsachen [hereinafter cited as RGZ] 238; German Supreme Court, Feb. 4, 1897, 38 RGZ, 155.

²¹ *Cf.* the comments by Isay, *op. cit. supra* note 17, at 32; Kronstein & Leighton, *supra* note 17, at 302; Schwartz, *supra* note 17, at 626-31.

²² Isay, *op. cit. supra* note 17, at 37.

²³ *Id.* at 34 and 35.

²⁴ *Id.* at 36.

ion;²⁵ enacted the famous Ordinance Against Abuse of Economic Power, the so-called Cartel Ordinance, which remained the principal basis of German law on that subject until the advent of Nazism. This measure refrained from an outright prohibition of combinations in restraint of trade and provided merely for the suppression of certain abusive practices and a limited governmental supervision.²⁶

The Ordinance applied, with one exception, only to cartels, syndicates, and similar arrangements, defined (in Section 1) as "agreements and resolutions which establish obligations with reference to the modes of production or marketing, the application of conditions of doing business and the calculation or charging of prices." Accordingly, it governed only horizontal arrangements between independent enterprises, entered into for the purpose and with the intent of influencing market conditions.²⁷ As a result purely vertical price maintenance schemes, that is, price fixing agreements between a single manufacturer, or wholesaler, and one of his customers, or all of his customers separately, did not fall under the sweep of the Ordinance. Price maintenance arrangements enforced by cartels, however, were covered by the statutory provisions.²⁸

The Ordinance required the agreements and resolutions governed by it to be in writing and declared void any such agreements or resolutions which the parties thereto promised to observe by giving their word of honor or making similar solemn assurances. It attempted to forestall an excessive stranglehold of cartels on the market by four types of legal devices specified primarily in Sections 4, 8, 9, and 10. The first of the indicated Sections empowered the Minister of Economics to intervene for the protection of the national economy or the public welfare and to:

- 1) institute proceedings for the complete or partial cancellation of the cartel agreement in the newly created Cartel Court, or
- 2) subject it to an unconditional right of withdrawal by its members, or
- 3) establish censorship over all of its actions.

²⁵ *Id.* at 40.

²⁶ Leading German commentaries on the Ordinance of 1923, as amended, are LEHNICH-FISCHER, *DAS DEUTSCHE KARTELLGESETZ* (1924); ISAY-TSCHIRSCHKY, *KARTELLVERORDNUNG* (1925); MÜLLENSIEFEN-DÖRINKEL, *KARTELLRECHT* (3rd ed. 1938). For an English discussion of the pertinent provisions and their application, see Kronstein & Leighton, *supra* note 17.

²⁷ For a detailed discussion of the cartel concept as developed by the German Supreme Court: MÜLLENSIEFEN-DÖRINKEL, *op. cit. supra* note 26, at V, 11.

²⁸ See the references in MÜLLENSIEFEN-DÖRINKEL, *op. cit. supra* note 26, at V, 12.

Section 8 gave each cartel member the right to withdraw from the cartel whenever there was an important reason for such step.

Section 9 subjected cartel actions forfeiting deposits or imposing boycotts or similar sanctions to a preliminary authorization by the presiding judge of the Cartel Court, whose decision was subject to review by the whole bench.²⁹ This tribunal also had jurisdiction over contested withdrawals by cartel members pursuant to Section 8.

Finally, Section 10 permitted the Cartel Court to authorize aggrieved parties to rescind contracts with cartels, combines, or trusts, where the conditions of doing business or the pricing practices were apt to threaten the national economy or the public welfare in exploitation of a dominant market position. Contracts concluded under identical conditions, after such determination by the Cartel Court, were declared void *ab initio*.

Section 10 was thus the only provision in the Ordinance which was applicable, not only to cartels in the technical sense, but also to other organizations with a dominant market position, such as trusts and combines. The Section, however, was of little practical significance since in the case of cartels the right of intervention under Section 4 was more comprehensive and more direct. An amendment of 1933 further increased the advantage of a reliance on Section 4 by eliminating the necessity of a proceeding in the Cartel Court and authorizing the Minister of Economics to pronounce immediately the total or partial nullity of cartel agreements or resolutions of the specified type.³⁰

The actual application of Sections 4, 8, and 9 produced difficult questions of interpretation and economic policy and has evoked retrospective censure by respected students of the field.³¹

The most comprehensive and most perplexing of the provisions mentioned was the requirement of administrative or quasi-judicial authorization for boycotts and similar exclusionary measures, imposed by cartels for the enforcement of discipline against defecting members or for extension of the organization to outsiders. The Cartel Court considered as measures needing prior approval all

²⁹ Section 9, para. 4, authorized the Minister of Economics to confer jurisdiction over the initial determination of the propriety of exclusionary measures of cartels operating only in individual German states or parts thereof to local authorities instead of leaving it with the presiding judge of the Cartel Court.

³⁰ Law of July 15, 1933, [1933] Reichsgesetzblatt [hereinafter cited as RGBl.] 487. See MÜLLENSIEFEN-DÖRINKEL, *op. cit. supra* note 26, at VI, 13.

³¹ See especially Kronstein & Leighton, *supra* note 17; Schwartz, *supra* note 17, at 639ff.

bars excluding an enterprise from customary business dealings.³² Authorization was to be refused if the contemplated action entailed a threat to the national economy or the public welfare or constituted an undue restriction of his freedom of action in the economic field for the party involved. The Cartel Court deemed such situation to be present if the boycott sought the expulsion of a competitor from the market, but not, at least according to later decisions,³³ if it merely aimed at pressure to make him join the cartel. Unauthorized action by the cartel entitled the aggrieved party to damages and injunctive relief in the ordinary courts of justice. An amendment of 1932, however, predicated such remedy upon prior declaration by the Cartel Court of a violation of Section 9.³⁴

The power of partial or total cancellation of cartel agreements in the interest of the national economy or public welfare, entrusted to the Minister of Economics by Section 4, permitted theoretically an even more radical and flexible governmental intervention, both before and after the abolition of judicial review in 1933. However, it is doubtful whether any really effective use was ever made of this possibility.³⁵ At any rate, the mere fact that an agreement was annulled did not render it void or illegal with retrospective effect.³⁶

Beginning with 1930 the Cartel Ordinance was supplemented by a series of enactments designed to implement the deflationistic policies of the government by either facilitating or ordaining a lowering of the price level. Accordingly, an emergency decree by the President of the Republic in 1930 authorized the government to invalidate price fixing agreements, whether in form of horizontal arrangements or of vertical agreements between a manufacturer or wholesaler and individual retailers, if they either constituted an obstacle to economical production or distribution of goods and services or entailed an unwarranted restriction on the freedom of action in the market.³⁷ Pursuant to the powers under this decree, the government invalidated agreements between a supplier and his purchaser which obligated the latter to observe specified pricing practices with respect to goods of another type or from another

³² MÜLLENSIEFEN-DÖRINKEL, *op. cit. supra* note 26, at VIII, 5.

³³ *Id.* VIII, 6; Kronstein & Leighton, *supra* note 17, at 310.

³⁴ Law of June 14, 1932, c.VI, art. 1, [1932] RGBl. 285, 289; MÜLLENSIEFEN-DÖRINKEL, *op. cit. supra* note 26, at VIII, 31 and 35.

³⁵ Kronstein & Leighton, *supra* note 17, at 313.

³⁶ MÜLLENSIEFEN-DÖRINKEL, *op. cit. supra* note 26, at VI, 8.

³⁷ Emergency Decree of July 26, 1930, c.5 §§ 1-5, [1930] RGBl. 311, 328; See MÜLLENSIEFEN-DÖRINKEL, *op. cit. supra* note 26, IV, 26.

source or with respect to services rendered in connection with the supplied goods. Price fixing arrangements relating merely to the goods purchased thus remained unaffected and valid.³⁸

In 1931 the government ordered a lowering by 10% of all prices set in vertical price fixing agreements pertaining to trademark-protected goods.³⁹ A further lowering by 10% of prices set in all price fixing agreements, whether of the horizontal or the vertical type, was prescribed by a subsequent ordinance of the same year.⁴⁰

As a result German law of this period outlawed directly only a very limited type of restrictive agreements, and, in general, pursued a case-by-case approach to abuse control. Invalidity or tortiousness of certain agreements, however, could be based, in especially oppressive cases, upon the Statute Against Unfair Competition or the general provisions relating to invalidity of legal transactions (Section 138) and anti-social infliction of injury (Section 826) of the Civil Code.⁴¹

(3) *Developments in the Third Reich.* The radical change in governmental philosophy and policy which occurred with the advent to power of the Nazi leaders in 1933 left cartels undisturbed at first, but in the course of time transformed them into instruments of the totalitarian regime and, finally, in 1943 practically suppressed them. Little could be gained from tracing this development in detail, but a few major stops on the road are worth discussing.

A statute of 1933, amending the Cartel Ordinance, abolished the need of judicial proceedings for the total or partial invalidation of cartel agreements by the Minister of Economics under Section 4 and extended the permissibility of boycotts and exclusionary measures against enterprises managed by unreliable persons.⁴² At the same date a further statute was enacted which provided for the compulsory cartelization of enterprises or the compulsory extension of cartels to outsiders if the Minister of Economics deemed it to be in the interest of the enterprises concerned, the economy as a whole, and the public welfare.⁴³ In connection with such measures, the Minister was also empowered to re-define the rights and duties

³⁸ *Id.* XV, 12 and XV, 18.

³⁹ For the text of the decree: *id.* IV, 29.

⁴⁰ For the text: *id.* IV, 32.

⁴¹ See in this connection Kronstein & Leighton, *supra*, note 17, at 325; Schwartz, *supra* note 17, at 632.

⁴² See *supra* note 30 and MÜLLENSIEFEN-DÖRINKEL, *op. cit. supra* note 26, at III.

⁴³ For the text: see MÜLLENSIEFEN-DÖRINKEL, *op. cit. supra* note 26, at IV, 11.

of the cartel members. Moreover, the Minister was authorized to prohibit the establishment of new enterprises or the expansion of existing facilities in a market if such action appeared to be necessary in view of the exigencies of this branch of the industry and the national economy as a whole. This statute, which formed the basis for approximately sixty actual governmental interventions in the period between 1933 and 1938,⁴⁴ served as a model for similar legislation in Belgium and the Netherlands.⁴⁵

In December 1934 the Government prohibited all increases of prices controlled by private price-maintenance schemes,⁴⁶ and in 1936 the establishment of a general price-stop followed.⁴⁷ In addition, the Commissioner for Prices issued an Ordinance Relating to Price Maintenance Agreements or Recommendations for Goods Sold Under Trademarks, of Oct. 27, 1937, which did empower him to declare such agreements terminated and illegal.⁴⁸ As a consequence cartels lost all functions in price policies and became more and more semi-public instruments for market regulation.⁴⁹ In 1943 their total replacement by government agencies was completed.⁵⁰

b. *The Interlude of Allied Legislation*

Following the surrender by Germany, Allied policy turned toward a de-concentration of the German industry and a suppression of cartels.⁵¹ The so-called Potsdam Agreement of August 2, 1945, contained a paragraph which provided:

At the earliest practicable date, the German economy shall be decentralized for the purpose of eliminating the present excessive concentrations of economic powers as exemplified in particular by cartels, syndicates, trusts and other monopolistic arrangements.⁵²

⁴⁴ See the survey in MÜLLENSIEFEN-DÖRINKEL, *op. cit. supra* note 26, at XII, 47-54 and 59.

⁴⁵ See part II, sections C and D of text *infra*.

⁴⁶ See MÜLLENSIEFEN-DÖRINKEL, *op. cit. supra* note 26, at IV, 53.

⁴⁷ *Id.* IV, 66.

⁴⁸ For details: *id.* IV, 74 and XV, 85. The Ordinance was superseded by another ordinance relating to price-maintenance arrangements of November 23, 1940, [1940] RGBl.I, 1573.

⁴⁹ For details, see MÜLLENSIEFEN-DÖRINKEL, *op. cit. supra* note 26, at XIV, 1ff.

⁵⁰ Cartel-Cleanup Decree (Kartellbereinigungserlass) of the German Minister of Economics, May 20, 1943, issued pursuant to the authority contained in the Market-Supervision Ordinance of October 20, 1942, [1942] RGBl.I, 619.

⁵¹ For further references: ISAY, *op. cit. supra* note 17, at 63; Schwartz, *supra* note 17, at 642.

⁵² Report on the Tripartite Conference of Berlin (Aug. 2, 1945), Official Gazette of the Control Council for Germany, Supp. No. 1, at 15 (April 30, 1946).

This agreement was implemented by separate enactments of the Control Powers, in consequence of the impossibility of reaching an understanding between the Soviet and the Western Powers.

In the three Western Zones the pertinent policies were carried out by two types of action. On the one hand there were special de-concentration proceedings against particular giant combines in the coal and steel industry, the chemical industry, the motion picture industry, and in banking, initiated on the basis of individual legislation.⁵³ These proceedings aimed at and, in part, accomplished an at least temporary restructuring of the particular sectors of the German economy. On the other hand, in each of the three Western Zones the military occupation authorities, in 1947, also enacted general legislation for the curtailment of restrictive business practices. The laws for the American and British Zones⁵⁴ were alike. They were patterned after the antitrust legislation in the United States, but were much more detailed and specific in their prohibitions and, in certain respects, went considerably beyond the thrust of the American original. The French law was considerably less detailed and somewhat more tolerant towards cartels.⁵⁵

The pertinent legislation was kept in force and in Allied hands even after the creation of the Federal Republic of Germany in 1949, by virtue of a specific reservation of such power in section 2b of the Occupation Statute of that year.⁵⁶ The termination of the occupation regime in 1955, pursuant to the so-called Paris agreements, returned to Germany "the full authority of a sovereign state over its internal and external affairs."⁵⁷ It was agreed between Germany and the three Allied Powers that until repeal or amendment, in accordance with the German Basic Law, legislation enacted by the Occupation Authorities should remain in force,⁵⁸

⁵³ See Schwartz, *supra* note 17, at 646.

⁵⁴ For the U.S. Zone and Bremen: Law No. 56, Military Government Gazette, Germany, United States Area of Control, issue C, at 2 (1947); for the British Zone: Ordinance No. 78, 16 Military Government Gazette, Germany, British Zone of Control 412 (1947). The catalogue of anticompetitive practices in art. V, Sec. 9(c) is of particular interest as it served as a model for subsequent European legislation.

⁵⁵ For the French Zone: Military Government Ordinance No. 96, June 9, 1947, 2 Journal Officiel du Commandement en Chef Français en Allemagne 784 (1947); see Schwartz, *supra* note 17, at 643.

⁵⁶ The reserved powers covered "Decartelisation, Deconcentration [and] Nondiscrimination in Trade Matters"; for a reprint of the text, see 43 AM. J. INT'L. L. SUPP. 172 (1949).

⁵⁷ Convention on Relations between the Three Powers and the Federal Republic of Germany, signed at Paris, October 23rd, 1954 and in force May 5th, 1955, art. 1, para. 2; see 49 AM. J. INT'L. L. SUPP. 57 (1955).

⁵⁸ Convention on the Settlement of Matters Arising out of the War and the Occupa-

and specific provisions were stipulated for the status of the coal mining and iron and steel industries and for the completion of the liquidation of the German Dye Trust.⁵⁹

The Allied legislation against the concentration of economic power, accordingly, remained valid and applicable by German authorities until the entry into force on January 1, 1958, of the new Law Against Restraints of Competition, promulgated on July 27, 1957. As a result, the German Ministry of Economics, as well as the German courts, were confronted with many difficult questions of interpretation regarding the validity or legality of cartels or other activities in restraint of trade, challenged under Laws Nos. 56, 78, and 96. Generally speaking, the German authorities, in construing the applicable legislation, looked to American precedents and practices for guidance and thus had to familiarize themselves with non-indigenous notions and traditions. It was therefore recognized by the interested and responsible quarters as early as 1952 that there ought to be a prompt replacement of the Allied enactments by a modern German law which, combining the experiences both under the Cartel Ordinance of 1923 and under the Allied Law Against Concentration of Economic Power, would produce a social market-order suitable to the political and economic climate in the young republic and in harmony with the basic tenets of German judicial administration.⁶⁰

tion, signed at Paris, Oct. 23, 1954, in force May 5, 1955, art. 2, para. 1; see 49 AM. J. INT'L. L. SUPP. 69 ff. (1955).

⁵⁹ *Id.* arts. 9 and 11. A special chapter pertaining to decartelization and deconcentration, contained in the 1952 version of the Convention, was deleted in 1954; see 49 AM. J. INT'L. L. SUPP. 77, 78, (1955). But the German government committed itself, by letter of October 23rd, 1954 addressed to the High Commissioners, to guarantee the maintenance of free competition in the future German Law. [1955] Bundesgesetzblatt [hereinafter cited as BGBl.] II, 482.

⁶⁰ The government bill which finally, and after considerable modification, became law in 1957 was first introduced in the German Parliament in 1952. Two prior government projects both drafted in 1949 failed because the first of them proceeded too much on a policy of state intervention, while the second one was unacceptable to the Occupation Powers as leaving too much freedom to cartelization. For a history of these drafts see the General Report by Dr. Hellwig in the Report on the Draft Law against Restraints of Competition of the Committee for Economic Policy, *Schriftlicher Bericht des Ausschusses für Wirtschaftspolitik* (21. Ausschuss) *über den Entwurf eines Gesetzes gegen Wettbewerbsbeschränkungen*, Deutscher Bundestag, 2. Wahlperiode, zu Drucksache 3644, 1 *et seq.* (1957).

2. THE ERA OF LAW AGAINST RESTRAINTS OF COMPETITION OF JULY 27, 1957

a. *Character and Scope in General*

(1) *Background and basic structure of the Law.* The promulgation on July 27, 1957, of the new Law of Competition marked the conclusion of a prolonged and bitter controversy between two opposing schools of thought.⁶¹ One, advanced in particular by the German National Association of Manufacturers (B.D.I.), harked back to the dogma of freedom of contract and the traditional differentiation between good and bad cartels and opposed any legislative intervention except for the purpose of curbing abuses;⁶² the other, represented by the German Minister of Economics, proceeded on the teachings of the neo-liberalist doctrine and advocated a policy of prohibiting, at least in principle, any restrictive arrangements, especially those of a horizontal type, with provisions for dispensation in exceptional cases. Ultimately the latter approach was adopted. However, by way of compromise, concessions had to be made in form of a lengthy catalogue of classes of enterprises exempted outright from the regulation of the act and of a number of exceptions and possible dispensations from the prohibition against restrictive arrangements if the same are entered into for particular purposes or under special circumstances.

The new Law,⁶³ which aims at a comprehensive regulation of the law relating to restrictive business practices,⁶⁴ is arranged in

⁶¹ The original governmental bill was transmitted to the German House of Representatives (Bundestag) on June 13th, 1952, and was transferred to its Committee on Economic Policy, following a general debate on June 26th, 1952. Preoccupation with other matters prevented the completion of the deliberations prior to the end of the legislative period. Early in 1954 the German Government decided to re-introduce the bill in the Second Parliament. The Senate (Bundesrat) voted in favor of a number of modifications, and the bill, with the observations of the Government on the changes proposed by the Senate, did not reach the House of Representatives until January 1955. It was finally passed by that body on July 3rd, 1957 and by the Senate, July 19th, 1957.

⁶² For details: Schwartz, *Antitrust Legislation and Policy in Germany—A Comparative Study*, 105 U. PA. L. REV. 617, 621 (1957).

⁶³ Gesetz gegen Wettbewerbsbeschränkungen [hereinafter cited as Restraints of Competition Law], [1957] BGBl. I, 1081. An English translation of the Law was published by the U.S. Dept. of Commerce, World Trade Information Service, pt. I, No. 58-1 (1958). The new Law repealed all prior statutes and decrees on the subject. The decree of March 9, 1932 prohibiting bonuses to customers in form of free merchandise or services and the Law of Nov. 25, 1933, regulating discounts remain in force.

⁶⁴ Commentaries on the new Law are KAUFMANN, RAUTMANN, STRICKRODT, U.A., FRANKFURTER KOMMENTAR ZUM GESETZ GEGEN WETTBEWERBSBESCHRÄNKUNGEN (1958);

six main titles containing, consecutively, provisions for the substantive law of restraints of competition; sanctions; administrative agencies charged with the application of the act; procedure; exempted categories of enterprises; and transitional and concluding matters. The two titles laying down the operative rules and the exemptions therefrom obviously constitute the core of the new legislation. Title One, specifying the various restrictive practices envisaged by the Law, divides its subject in turn into six chapters, dealing with: (1) cartels, (2) other restrictive agreements, (3) enterprises with dominating market power, (4) additional restrictive or discriminatory practices, (5) codes of competition, and (6) formal requirements and civil sanctions.

As can be inferred from this list, the Law focuses on, and differentiates among, four principal classes of restrictive practices—restrictions in the form of arrangements or resolutions of the horizontal type (cartels); restrictive agreements of vertical character; abusive exploitation of a monopoly or oligopoly; and, finally, discriminatory and coercive practices not falling within the aforementioned three categories.

(2) *Cartel agreements and cartel resolutions*

(a) *Section 1 of the Law.* Section 1 of the Law announces the basic policy toward cartels:

Agreements between enterprises or associations of enterprises, concluded for the accomplishment of a common purpose, and resolutions of associations of enterprises are invalid to the extent that they are apt to affect the production or the market conditions for the commerce in goods or occupational services by means of restraints of competition. This does not apply where this Law provides otherwise.

As indicated by the “does-not-apply” clause and as mentioned before, the principle of invalidating cartel agreements and decisions is limited by far-reaching exceptions and provisions for executive dispensations.

Generally speaking, in the cases of the statutory exceptions the cartel agreements and resolutions falling within their scope are either valid if properly filed with the Cartel Office⁶⁵ or become

LANGEN, KOMMENTAR ZUM KARTELLGESETZ (3d. ed. 1958); MÜLLER-GRIES, KOMMENTAR ZUM GESETZ GEGEN WETTBEWERBSBESCHRÄNKUNGEN (1958); MÜLLER-HENNEBERG, SCHWARTZ, GESETZ GEGEN WETTBEWERBSBESCHRÄNKUNGEN, KOMMENTAR (1958); RASCH, WETTBEWERBSBESCHRÄNKUNGEN, KARTELL-UND MONOPOLRECHT (1957).

⁶⁵ Restraints of Competition Law § 9 (2). In only one case—that of cartel agreements

valid upon expiration of three months from such filing, unless the office raises objections for specified reasons within such period.⁶⁶ The Cartel Office subsequently may declare them to be invalid if such action is necessary to suppress abuses of market power gained through the statutory privilege.⁶⁷ Conversely, in the cases of permissive dispensation by the Executive, the cartel agreements and resolutions subject thereto need prior authorization to be valid⁶⁸ and are rendered invalid by the expiration of the period of authorization without renewal or by revocation of the authorization based on the grounds specified by the Law.⁶⁹

(b) *Statutory exceptions.* The statutory exceptions encompass five categories of cartel agreements or resolutions which are deemed to exert no, or only relatively minor, restraints on competition in domestic markets. These five classes are agreements and resolutions which

- 1) serve merely for the protection and promotion of exports without regulation of competition in domestic markets (*pure export cartels*);⁷⁰ or
- 2) provide for uniform methods of stating specifications for goods and services or of itemizing prices (without price fixing) in industries where prior inspection is not feasible (*quotation cartels*);⁷¹ or
- 3) provide for uniform application of the general terms of doing business, delivery, or payment, including discounts (*conditions cartels*);⁷² or
- 4) regulate rebates which represent genuine compensation for services rendered and do not entail discrimination between different levels of distribution or between customers on the same level who, in taking delivery, perform the same services to their suppliers (*rebate cartels*);⁷³ or

or decisions regulating uniform methods of stating specifications for goods and services or of itemizing prices without fixing prices or price components—does the Law refrain from making filing a condition for their validity, although prompt filing is imposed as duty upon the parties. *Id.* § 9(2).

⁶⁶ Restraints of Competition Law §§ 2(3), 3(3) and 5(1), governing the validity of conditions cartels, rebate cartels and rationalization cartels.

⁶⁷ *Id.* §§ 12; see also § 3(4).

⁶⁸ *Id.* § 11(1).

⁶⁹ *Id.* § 11(5).

⁷⁰ *Id.* § 6(1).

⁷¹ *Id.* § 5(4).

⁷² *Id.* § 2(1).

⁷³ *Id.* § 3(1).

- 5) regulate uniform application of standards or types (*standardization cartels*).⁷⁴

In the case of the rebate cartels, the Cartel Office may base its initial objection on the ground that it is evident that the agreement or resolution in question has harmful effects on the course of production or trade or on supplying consumers adequately or, in particular, that it renders the entry into a trade on a given level of distribution more difficult. Moreover, initial objection or subsequent intervention may be rested on the fact that market participants have shown that they are subject to discrimination by reason of the agreement or resolution in question.⁷⁵

(c) *Categories of cartel agreements and resolutions.*

In addition, the Law enumerates six categories of cartel agreements and resolutions, the validity of which depends on previous executive authorization (*authorization cartels*). These *dispensations* are provided for on the theory that the cartel agreements or decisions of the particular type, though normally exerting undue restraint on competition, may be desirable in view of special conditions or emergencies in the particular industry or in the interest of the national economy as a whole.

These cartel agreements and resolutions for which authorization may be obtained cover the cases in which the particular action

- 1) is taken, in response to a decline in sales based on a permanent change in demand, by enterprises engaged in the production, manufacture, or processing of goods, provided that the agreement or resolution is needed for an orderly adjustment of the productive capacity to market conditions and that the regulation takes the national economy as a whole and the general welfare into account (*structural crises cartels*);⁷⁶ or
- 2) constitutes regulation which serves to rationalize economic processes and is apt substantially to enhance the productivity or profitability of the enterprises involved in technological, administrative, or organizational respects, and thus to improve their capacity to satisfy demand, provided that the advantages of the rationalization are reasonably propor-

⁷⁴ *Id.* § 5(1).

⁷⁵ *Id.* §§ 3(3) and 3(4).

⁷⁶ *Id.* § 4.

tionate to the restraint of competition effected thereby (*simple rationalization cartels*); ⁷⁷ or

- 3) effectuates rationalization in conjunction with price fixing or the establishment of common agencies for procurement or marketing (syndicates), provided that the goal of rationalization cannot be achieved in any other way and that the rationalization is desirable in the public interest (*rationalization cartels of higher order*); ⁷⁸ or
- 4) serves to protect and promote exports in cases in which regulation affects commerce in goods and services in domestic markets, provided, and to the extent, that it is required to safeguard the intended regulation of competition in foreign markets (*export cartels affecting domestic commerce*); ⁷⁹ or
- 5) regulates solely imports into the area governed by the Law and is confined to situations where the German consumers of the imports are confronted with no or only insubstantial competition (*import cartels*); ⁸⁰ or
- 6) does not fall within the aforementioned categories, but where a restraint of competition is necessary for exceptional reasons of the paramount interest to the national economy and the general welfare or where there is an immediate danger threatening the survival of the major part of the enterprises in a branch of industry, provided that there is no, or no timely, possibility that other legislative or economic measures can be taken and that the restraint of competition is apt to avert the danger (*emergency cartels*). ⁸¹

In the first five of these classes, the Cartel Office is entrusted with the grant or denial of applications for authorization. The emergency powers which become operative in the sixth category, however, are reserved to the Federal Minister of Economics. The Law surrounds the exercise of the discretion of the Cartel Office or the Minister of Economics, in the disposition of applications for grants or renewals of authorizations, with a number of additional special formal or substantive safeguards other than the conditions

⁷⁷ *Id.* § 5(2). Cartels providing for rationalization through specialization may be authorized only if the specialization does not foreclose competition in the market.

⁷⁸ *Id.* § 5(3).

⁷⁹ *Id.* § 6(2).

⁸⁰ *Id.* § 7.

⁸¹ *Id.* §§ 8(1) and 8(2).

mentioned above.⁸² A detailed discussion of them seems, however, unnecessary.

Cartel agreements and resolutions which are valid either because they fall within one of the five statutory exceptions or because they belong to one of the six classes for which prior authorization by the Cartel Authority may be secured and they, in fact, have been so authorized, are, nevertheless, subject to a right of withdrawal for important cause by any of the participants.⁸³ The Law specifies that an important cause is deemed to be present in particular if the freedom of economic action of the person asserting such right is either curtailed to an undue degree or impaired by discriminatory unequal treatment in comparison with that of the other participants.⁸⁴

(3) *Vertical restrictive agreements.* The second chapter of Part I of the Restraints of Competition Law⁸⁵ deals with the validity of restrictive agreements of the vertical type, such as contract provisions for resale price maintenance, exclusive dealing, ties, and the like. In appraising the scope of this regulation, one must keep in mind at the outset that it is supplemented by a special chapter dealing with restrictive practices by an enterprise or enterprises possessing dominant market power.⁸⁶

(a) *Treatment of agreements imposing resale prices or other contractual terms.* The Law differentiates the treatment of agreements imposing resale prices or other contractual terms from that of other vertical restrictive stipulations. The basic rule with respect to the former is contained in Section 15 which provides:

Agreements between enterprises with respect to goods or occupational services which apply to domestic markets are void to the extent that they restrict one of the parties thereto in its freedom to determine prices or other terms in the contracts which such party may conclude with third parties in regard to the goods so supplied, other goods or occupational services.⁸⁷

This general proscription of vertical price fixing is, however, rendered inapplicable to the most common cases of resale price

⁸² *Id.* §§ 2(2), 3(2), 3(3)1-3, 5(3) last sentence, 6(2) last sentence, 7(2), 8(3), 11, 12.

⁸³ *Id.* § 13(1).

⁸⁴ *Ibid.*

⁸⁵ *Id.* §§ 15-21.

⁸⁶ *Id.* §§ 22-24.

⁸⁷ *Id.* § 15.

maintenance agreements covering trademarked or brand goods (as defined by the Law) or products of publishing houses.⁸⁸ In defining the exact scope of this exception with respect to trademarked or brand goods the Law requires that they be subject to price competition by similar goods of other producers or dealers. Furthermore, the exception applies only to the goods or publications which are supplied by the enterprise imposing resale price maintenance, but it extends to arrangements with legal or economic force and permits stipulations for the imposition of the same obligation upon subsequent customers down to the resale to the ultimate consumer. The concept of trademarked or brand goods is broadly defined and includes all products which the enterprise imposing resale maintenance guarantees to supply in identical or improved quality and which carry on their body, wrapping, or container a mark identifying their origin (whether consisting in a designation of the firm, a word, or picture).⁸⁹

The resale price maintenance contracts for trademarked goods are not valid unless filed with the Cartel Office accompanied by complete information concerning all imposed resale prices or margins of profit.⁹⁰ The Cartel Office may institute proceedings to declare a price-fixing agreement inoperative, either with immediate effect or beginning at a specified future date, and to prohibit execution of a new price-fixing stipulation of similar content, if: the conditions for its validity are not, or no longer, fulfilled; its enforcement engenders abuse; or the price-fixing agreement by itself or in combination with other restraints of competition is apt to increase the price for the protected goods, prevent a reduction in their price, or curtail their production or distribution in a manner not justified by general economic conditions.⁹¹ As the wording of this provision shows, the authority of the Cartel Office to invalidate price-fixing agreements is neither exclusive of, nor coextensive with, the power of ordinary courts of justice to hold agreements of that type void or unenforceable in controversies between particular parties because the conditions of their validity were not met at the time they were concluded or subsequently ceased to be fulfilled.⁹²

⁸⁸ *Id.* § 16(1), 1 and 2.

⁸⁹ *Id.* § 16(2).

⁹⁰ *Id.* § 16(4).

⁹¹ *Id.* § 17(1).

⁹² LANGEN, *op. cit. supra* note 64, § 17, II, 3; Schwartz in MÜLLER-HENNEBERG, SCHWARTZ, *op. cit. supra* note 64, § 17, 20.

(b) *Exclusive dealing; tie-ins; use of resale restrictions.* In addition, the Law specifies four other types of vertical restrictive agreements which, while not proscribed or rendered void on principle, may nevertheless call for an intervention by the Cartel Office whenever they have certain specified undesirable effects.⁹³ The four categories so envisaged are contracts between enterprises with respect to goods or occupational services which impose upon one of the parties thereto:

- (1) restraints in the free use of the goods supplied, other goods or professional services, or
- (2) restraints in the procurement of other goods or services from third parties or in the supply thereof to third parties, or
- (3) restraints in the resale of the goods supplied to third parties, or
- (4) obligations to receive goods or occupational services which are not connected therewith by nature or commercial custom.

The Cartel Office may intervene in these types of agreements and declare the stipulations of the indicated content to be inoperative, either with immediate effect or to begin at a specified future date, to the extent that such restrictions limit unfairly the freedom of economic action of a party to the contract or of a third enterprise and that their scope impairs substantially the competition in the market for these or other goods or occupational services.

(c) *Restrictions attached to the transfer or licensing of patents, other rights of industrial property or technological know-how.* The Law contains special regulations applicable to restrictions placed on the assignee or licensee of patents, utility models, or other rights of industrial property as well as to restrictions imposed in connection with the sale or lease of non-patented inventions, manufacturing processes, blueprints, and similar technological know-how.⁹⁴

The basic rule is contained in Section 20(1) which provides:

Contracts respecting the acquisition or the use of patents, utility models, or exclusive rights in brands are invalid to the extent that they impose upon the assignee or licensee any restrictions in his dealings which exceed the scope of

⁹³ Restraints of Competition Law § 18(1) and (2).

⁹⁴ *Id.* §§ 20, 21.

the statutory privilege; restrictions concerning the mode, extent, quantity, territory or period of the exercise of the privilege do not exceed the scope thereof.

But this principle is qualified by a catalogue of five types of restrictions which do not come within the purview of Section 20(1), if they do not exceed the duration of the statutory industrial property right which is the object of the assignment or license.⁹⁵ These restrictions are:

- (1) limitations of the assignee or licensee, insofar and as long as they are justified by an interest of the assignor or licensor in a technically unobjectionable exploitation of the object of the statutory privilege;
- (2) obligations of the assignee or licensee with respect to the price charged for the protected article;
- (3) obligations of the assignee or licensee to exchange experiences or to license improvement or new use patents, provided that there are corresponding obligations of the patentee or licensor;
- (4) obligations of the assignee or licensee not to contest the validity of the statutory right involved;
- (5) obligations of the assignee or licensee to the extent that they relate to the regulation of competition in non-domestic markets.

In addition, the Cartel Office may authorize the conclusion of agreements, otherwise invalid under Section 20(1), if neither the freedom of economic action of the assignee or licensee or of other enterprises is unfairly restricted nor the extent of the restrictions substantially impairs competition.⁹⁶ Cases of this type are, for example, assignments or licenses of process patents coupled with the obligation of the assignee or licensee to procure the necessary materials from the assignor or licensor.⁹⁷

The statute provides expressly that the regulations regarding cartels remain applicable,⁹⁸ evidently in order to provide for cases where the restrictive agreements pertaining to patents and similar rights possess cartel elements, that is, horizontal features.

The same rules apply with respect to agreements concerning the

⁹⁵ *Id.* § 20(2).

⁹⁶ *Id.* § 20(3).

⁹⁷ See the observations to that effect in Chapter III by Dr. Hoffman, in the Report of the Committee on Economic Policy of the German Bundestag on the Draft Law against Restraints of Competition, *Schriftlicher Bericht des Ausschusses für Wirtschaftspolitik (21. Ausschuss) über den Entwurf eines Gesetzes gegen Wettbewerbsbeschränkungen*, Deutscher Bundestag, 2. Wahlperiode zu Drucksache 3644 (1957).

⁹⁸ Restraints of Competition Law § 20(4).

sale or lease of non-patented inventions, manufacturing processes, blueprints and technological know-how.⁹⁹

(4) *Abuse of dominant market power.* The Law contains a special regulation concerning the situation where a single enterprise or a group of enterprises enjoys a position of dominance in the market.¹⁰⁰ In such a case the Cartel Office is given the power to intervene in order to curb two types of anticompetitive practices if they amount to an abuse of dominant market power.

The two types of practices which may, under proper regard for all circumstances, be deemed to constitute an abuse of market dominance are:

- 1) the demand or offer of prices or the insistence on terms and conditions in the conclusion of contracts for goods or service;
- 2) the condition in the conclusion of contracts for goods and services that the other party take other goods and services unrelated by nature or commercial custom.¹⁰¹

The possible intervention by the Cartel Office in the case of such abuse consists in a prohibition of the objectionable practices and an invalidation of the respective contractual clauses.¹⁰²

The Law ascribes dominant market power to a single enterprise insofar as it is subject to no, or no substantial, competition in regard to certain goods or services. Two, or several, enterprises are deemed to dominate the market insofar as, for factual reasons, there exists no substantial competition between them with respect to a certain category of goods or occupational services or in particular markets and insofar as they, cumulatively, are subject to no, or no substantial, competition with respect to these items.¹⁰³ Where the several enterprises form a combine, the Cartel Office may take action against each individual constituent.

In addition,¹⁰⁴ the statute imposes a duty to notify the Cartel Office in cases of merger, acquisition of the assets or production facilities of other enterprises, management contracts, or acquisition of controlling stock in other enterprises if the resulting combination or one of the participating enterprises prior to the combination is in control of a share of the market in certain goods or services totalling or exceeding 20%.

⁹⁹ *Id.* § 21.

¹⁰⁰ *Id.* § 22.

¹⁰¹ *Id.* § 22(3).

¹⁰² *Id.* § 22(4).

¹⁰³ *Id.* §§ 22(1) and (2).

¹⁰⁴ *Id.* § 23.

If the Cartel Office, upon such notification, thinks that the combination results in, or increases, dominant market power, it may initiate the necessary inquiries.¹⁰⁵ The original government draft had subjected the combination of enterprises under particular conditions to a prior authorization by the Cartel Office. In the course of the parliamentary proceedings this requirement was reduced to a mere duty of notification.

(5) *Other restrictive or discriminatory practices.* The restrictive practices envisaged by the Law in Sections 1-8 (cartel agreements and resolutions) and in Sections 15-21 (vertical agreements) are of a direct and contractual or formal character. Since objectionable restrictions of competition may also result from indirect and non-contractual or non-formalized action, whether concerted or individual, the statute supplements the aforementioned provisions by a proscription of various additional restrictive practices not falling within the categories outlined so far, especially with a view to shielding outsiders. Moreover since cartels and enterprises with dominant or privileged status in the market are in a particularly sensitive position, the Law subjects their business transactions to special standards of fair and impartial dealing.

The final formulation of the Sections of this Chapter was the product of considerable parliamentary change in the original government bill, and thus the resulting organization of the material into four categories of prohibitions appears somewhat haphazard.¹⁰⁶

- 1) Section 25 (1) prohibits resort to pressures or incentives for the purpose of inducing evasions of the statutory limitations.

"Enterprises and association of enterprises, may neither threaten or inflict damages nor promise or grant advantages to other enterprises for the purpose of inducing them to a conduct which may not be the subject of a contractual undertaking, either because of a statutory mandate or an order issued pursuant to this Act."

- 2) Section 25 (2) proscribes coercion of outsiders which compels them to participate in permitted, though restrictive, practices.

"Enterprises or associations of enterprises may not coerce other enterprises to:

1. accede to a cartel agreement, trade association, or cartel resolution within the meaning of §§ 2 to 8, 29 . . . of this Act;

¹⁰⁵ *Id.* § 24.

¹⁰⁶ See the observations by LANGEN, *op. cit. supra* note 64, in his prefatory comments in ch. 4.

2. form a combination within the meaning of this Act with another enterprise;
3. pursue parallel conduct in the market for the purpose of restricting competition."

Accordingly, while conscious parallelism as such is not within the statutory bans, coercion thereto is taboo.

- 3) Section 26 (1) is directed against secondary boycotts, providing that

"... enterprises and association of enterprises may not, in order to harm particular competitors, induce other enterprises or associations of enterprises to impose boycotts with respect to supply or procurement."

- 4) Section 26 (2), finally, rounds out the list of "may-nots" by a mandate to the effect that

"... enterprises with dominant market power, cartels within the meaning of §§ 1 to 8, ... [listing certain special Sections of the Act] and enterprises which engage in resale price maintenance within the meaning of § 16 [and certain special Sections] may not unfairly hinder other enterprises, whether directly or indirectly in their business activities, usually open to similar enterprises, or discriminate, whether directly or indirectly between similar enterprises without adequate objective reasons."

This catalogue of prohibitions is followed by a concluding Section¹⁰⁷ which empowers the Cartel Office to order the admission of an enterprise into a trade association where the exclusion amounts to an unfair discrimination entailing competition disadvantages.

(6) *Codes of fair competition.* The Law authorizes trade associations to establish codes of fair competition for the purpose of combatting unfairness in the economic contest between members of the same section of commerce or industry.¹⁰⁸ The Cartel Office keeps a separate register for such codes and exercises a certain degree of supervision over the legality of the provisions of the codes thus filed for registration.¹⁰⁹ Observance of such registered rules of competition may be the subject of stipulations among the interested parties without running afoul of the general invalidation of cartel agreements.¹¹⁰

Whether or not a prohibition against, or insistence upon, par-

¹⁰⁷ Restraints of Competition Law § 27.

¹⁰⁸ *Id.* §§ 28(1) and (2).

¹⁰⁹ *Id.* §§ 28(3), and 31.

¹¹⁰ *Id.* §§ 29.

ticular business practices amounts to a legitimate rule of fair competition may often depend upon a careful case-by-case determination.¹¹¹

(7) *Exemptions and separate regulations for particular industries.* The Law contains exemptions of varying breadth as well as separate regulations for particular trades and industries.¹¹² The sectors of the economy thus set apart cover transportation and communications,¹¹³ agriculture,¹¹⁴ central banking and industries operated as public monopolies,¹¹⁵ insurance,¹¹⁶ and public utilities in the field of energy and water supply.¹¹⁷

The exemptions differ greatly as to their range. They may extend to all provisions of the Law¹¹⁸ or only to particular Sections thereof, especially to Sections 1 and 15-18,¹¹⁹ to Sections 1, 15, and 18,¹²⁰ or solely Sections 1 and 15.¹²¹ The details are too complex to warrant discussion in this survey.

b. *Administration; Sanctions and Liability for Infractions*

(1) *Scope and distribution of administrative responsibilities.* As has been pointed out, the basic invalidations by the Law of cartel agreements and of vertical agreements that restrict a recipient of goods or services in his freedom to contract in regard thereto with third parties, are tempered by broad exceptions and possibilities of dispensation, coupled with a prohibition against abuses. Similarly, enterprises with dominant market power are subject to certain standards and control against abuses.

As a result the Law had to establish both an elaborate administrative machinery and a number of formal requirements (such as reduction of agreements to writing, filing thereof with the Cartel Authority, and, in appropriate cases, entry in a special register) for the purpose of operating or facilitating the policing of the system.

Apart from the authorization of emergency cartels, which is reserved to the Federal Minister of Economics,¹²² the administrative

¹¹¹ LANGEN, *op. cit. supra* note 64, comments § 28, I, 2.

¹¹² Restraints of Competition Law pt. V.

¹¹³ *Id.* § 99.

¹¹⁴ *Id.* § 100.

¹¹⁵ *Id.* § 101.

¹¹⁶ *Id.* § 102.

¹¹⁷ *Id.* § 103.

¹¹⁸ *Id.* §§ 99(1) and 101.

¹¹⁹ *Id.* § 99(2) (high sea, coastal, and river navigation and port facilities).

¹²⁰ *Id.* §§ 100, 103 (agriculture and public utilities).

¹²¹ *Id.* § 102 (insurance and financing institutions).

¹²² See text to note 81 *supra*.

responsibilities for the proper application of the law are entrusted to the "Cartel Authority." Because of the political structure of the Federal Republic of Germany, the exercise of the powers and functions of the Cartel Authority are distributed among a new federal administrative agency, the Federal Cartel Office, and the top authorities for economic matters in the states constituting West Germany.

The Federal Cartel Office has exclusive jurisdiction over crises cartels, export and import cartels, resale price maintenance agreements, enterprises with dominant market power, mergers and assimilated transactions, as well as matters involving the federal railway and postal services.¹²³ The Federal Cartel Office likewise has jurisdiction where the effects of the conduct influencing the market, of the restraints of competition or discriminations, or of the rules of competition extend beyond the boundaries of an individual state; otherwise the latter matters are left to the state authorities.¹²⁴

The Law gives the Cartel Authority broad investigatory powers¹²⁵ and establishes elaborate procedural rules for administrative proceedings,¹²⁶ administrative rehearings¹²⁷ and judicial review of administrative decisions.¹²⁸

(2) *Penalties and tort liability for infractions.* Since the Restraints of Competition Law is essentially a regulatory and police measure, it is obvious that its effectiveness depends upon the availability of appropriate forms of compulsion. Accordingly, the Law provides for a system of fines to be imposed as penalty for the intentional disregard of the invalidity of certain types of agreements or resolutions, as specified in the various statutory provisions, or for the intentional violation of statutory prohibitions, as well as for the intentional or negligent disregard of the invalidity of an agreement or resolution flowing from an administrative declaration to that effect, and for the intentional or negligent violation of administrative orders or requirements.¹²⁹ In addition, the Law penalizes intentional furnishing of false or incomplete information for the purpose of obtaining an authorization or avoiding an objection,¹³⁰ and intentional inflicting of injuries on others because they

¹²³ Restraints of Competition Law §§ 44(1), 1.a), b), c) and e).

¹²⁴ *Id.* § 44, (1), 1.d) and 3.

¹²⁵ *Id.* §§ 46 and 47.

¹²⁶ *Id.* §§ 51-58.

¹²⁷ *Id.* §§ 59-61.

¹²⁸ *Id.* §§ 62-75.

¹²⁹ *Id.* § 38(1), 1, 8, 2, 4, 5, and 6.

¹³⁰ *Id.* § 38(1), 7.

have prompted orders by the Cartel Authority or exercised their right of withdrawal from a cartel.¹³¹

This catalogue of types of conduct penalized by fine is supplemented by a most important clause relating to the imposition of fines as penalty for mere *recommendations*. Such sanction is incurred in two cases. One is the intentional participation, by means of recommendations, in the violations specified above; the other consists of recommendations which effectuate an evasion of statutory prohibitions or orders of the Cartel Authority by means of parallel conduct.¹³² The Law, however, excepts recommendations of prices or price calculations, made by associations of enterprises to their members, if these recommendations have the purpose of creating competitive conditions vis-à-vis big enterprises or big combines and if such recommendations are expressly designated as non-binding and are not enforced by social, economic, or other pressure.¹³³

Undoubtedly some of the most important, but also most perplexing, problems in the administration of the new law will relate to the bearing of its provisions on the tort liability of enterprises engaging in restrictive practices.¹³⁴ Generally speaking, this question will be governed by the interaction between the general principles of tort liability, established by the German Civil Code, and the various provisions relating to the invalidity or proscription of certain practices by the Restraints of Competition Law. The Law contains only one specific Section in this connection,¹³⁵ which in part duplicates and in part enlarges an analogous section of the Civil Code.

The German Civil Code establishes three broad categories of conduct which entail liability in tort:

- 1) intentional or negligent and illegal inflicting of injury to the life, health, liberty, property or other absolute right of another;¹³⁶

¹³¹ *Id.* § 38(1), 9.

¹³² *Id.* § 38(2), first and second sentences.

¹³³ *Id.* § 38(2), third sentence.

¹³⁴ See in this connection especially: Gleiss & Kracht, *Missbrauchsbestimmungen des GWB als Schutzgesetz*, 12 NEUE JURISTISCHE WOCHENSCHRIFT [hereinafter cited as NJW] 971 (1959); Spengler, *Zivilrechtliche Auswirkungen des Kartellgesetzes*, 10 WIRTSCHAFT UND WETTBEWERB [hereinafter cited as WuW] 410, at 417 (1960). Schramm & Klaka, *Das Deliktrecht im Gesetz gegen Wettbewerbsbeschränkungen*, 4 WETTBEWERB IN RECHT UND PRAXIS 75 (1958); Benisch in MÜLLER-HENNEBERG, SCHWARTZ, *op. cit. supra* note 64, § 35(2)-(5).

¹³⁵ Restraints of Competition Law § 35.

¹³⁶ BÜRGERLICHES GESETZBUCH § 823, para. 1.

- 2) intentional or negligent violation of a statute, enacted for the purpose of protecting another;¹³⁷
- 3) other intentional and unethical inflicting of injury on another.¹³⁸

The Restraints of Competition Law duplicates and enlarges the second of these categories by imposing tort liability upon any contravention of any provision of the Law or of any order issued by the Cartel Authority or a court of review pursuant to the Law, insofar as such provision or order has the purpose of protecting another, and by providing for the recovery of exemplary damages in case of disobedience of a mandate ordering admission of the plaintiff into a trade association.¹³⁹

The question as to which provisions of the Law or orders by the Cartel Office or a court of review will be deemed to have the purpose of protecting another in the position of the plaintiff is liable to involve difficult policy considerations and cannot be answered with certainty at this stage. At any rate, the possibility of liability under the other two broad tort categories specified in the Code must be kept in mind, especially in view of the fact that an established and operating enterprise is recognized as a basis for an absolute right within the meaning of the Civil Code, Section 823 I, which is protected against intentional or negligent illegal invasion. However, the problem as to which restrictive practices may be deemed to be "illegal" and not merely "invalid" conceivably will have to be answered by applying the same tests that determine the protective purpose of the statutory provision or order invalidating them. A conclusive answer must likewise await further decisional clarification. Finally, it must be noted that the Law Against Unfair Competition of June 9, 1909, may furnish additional grounds for tort liability.

c. Initial Judicial and Administrative Experience

(1) *Categories of administrative operations.* It goes without saying that an act as broad and complex as the new Restraints of Competition Law is bound to produce countless practical uncertainties and controversies¹⁴⁰ and that its actual scope and

¹³⁷ *Id.* § 823, para. 2.

¹³⁸ *Id.* § 826.

¹³⁹ Restraints of Competition Law § 35.

¹⁴⁰ A complete bibliography of the ceaseless flood of articles and comments published

significance will depend on gradual administrative, judicial, and doctrinal classification.

A great deal about the initial experiences with the new Law can be gleaned from the first two annual reports of the Federal Cartel Office which were published in 1959 and 1960.¹⁴¹ As could be expected, the principal activities of the Federal Cartel Office, as well as of the state cartel authorities, consisted in the processing and, where appropriate, scrutiny of the vast number of notifications and registration statements submitted pursuant to the various mandates of the Law, in the examination of applications for authorization, as required for various categories of cartels or patent licenses containing restrictive clauses and assimilated stipulations, and in the investigation of the notifications relative to mergers and assimilated forms of economic concentration. Thus the Federal Cartel Office, during the first two years of its activities, received 144 notifications, or applications for authorization, of cartel agreements permitted by the Law under the conditions specified in Sections 2-7,¹⁴² and registration statements of 203,109 vertical price-fixing stipulations communicated by 1,056 firms.¹⁴³ Ten additional notifications, or applications for authorization, of cartel agreements were submitted to state authorities,¹⁴⁴ and the Federal Minister of Economics received three petitions for authorization under the general interest clauses of Section 8.¹⁴⁵

Of course, a substantial portion of the work load of the cartel

in the various learned or trade journals is practically impossible and hardly of interest to the non-German reader.

¹⁴¹ *Bericht des Bundeskartellamtes über seine Tätigkeit im Jahre 1958 sowie über die Lage und Entwicklung auf seinem Aufgabengebiet*, Deutscher Bundestag, 3. Wahlperiode, Drucksache 1000. (15 April 1959); *Bericht des Bundeskartellamtes über seine Tätigkeit im Jahre 1959 sowie über Lage und Entwicklung auf seinem Aufgabengebiet*, Deutscher Bundestag, 3. Wahlperiode, Drucksache 1795 (13 April 1960).

¹⁴² Report for 1959, *supra* note 141, at 96. The breakdown shows that 36 of these 144 notifications or applications were petitions for authorization of rationalization cartels with price agreements or common sales or purchase agencies under § 5(3), while another 48 were filings of export cartels without regulation of competition within Germany pursuant to § 6(1). The remaining 70 items involved all of the other seven allowed categories of cartels.

¹⁴³ *Id.* at 114. In addition, the Federal Cartel Office received 94 applications for authorization of patent and trade secret licenses containing restrictive stipulations, while 158 further licenses or assimilated agreements were submitted to it for examination. *Id.* at 43 and 118.

¹⁴⁴ *Id.* at 97.

¹⁴⁵ Report for 1958, *supra* note 141, at 2. One of these petitions involved the short-lived Coal-Fuel Oil Cartel which, *inter alia*, aimed at a restriction of the competition between oil and coal as industrial fuel, in order to protect the German coal industry against further increase of its existing dangerous overproduction. The petition was granted on February 17, 1959.

authorities consisted also in proceedings for the suppression of suspected violations of the statutory prohibitions or of suspected abuses. During the first two years the Law was in effect the Federal Cartel Office initiated 859 investigations of suspected violations, while state authorities instituted 824 such proceedings.¹⁴⁶ In each instance by far the greatest number of cases concerned violations of the general ban against horizontal agreements in restraint of trade.¹⁴⁷ In addition the Federal Cartel Office commenced 323 investigations of suspected abuses, primarily of vertical resale price maintenance agreements.¹⁴⁸

(2) *Particular judicial or administrative decisions.* In the course of the first two and one-half years of operation of the Law a number of important issues have come before the courts ^{148a} and administrative agencies. The High Court of Germany rendered its first leading opinion clarifying various basic aspects of the new Law in October 1958 in a suit between the two well-known rival manufacturers of eau de cologne, 4711 and Johann Maria Farina.¹⁴⁹ The former distributed its products under a genuine system of retail price maintenance agreements, while the latter did not operate under such an arrangement but published retail prices for its products on its price lists, bills of sale, brand labels, and advertisements. 4711 considered this practice of its competitor as a violation of the Restraints of Competition Law and the Law Against Unfair Competition and brought an action for a permanent injunction. The Court held that plaintiff was entitled to the relief prayed for. In reaching this result the Court considered the interrelation of Sections 15, 16(1), 16(4), and 38 of the Law and came to the conclusion that the *invalidity* laid down by Section 15 in general terms for vertical restrictive agreements extended to resale price maintenance agreements for articles sold under trademarks or manufacturers' brands, and that the exception provided for in Section 16(1) applied only to agreements properly registered with the Federal Cartel Office in accordance with Section 16(4). It held further that "invalidity" implied at the same time a "prohibition." Consequently, Section 38(2), prohibiting recommendations

¹⁴⁶ Report for 1959, at 125, 126.

¹⁴⁷ *Ibid.* The Federal Cartel Office started 424, and the state authorities 546, proceedings against purported § 1 violations.

¹⁴⁸ *Id.* at 122. Abuse proceedings under § 17 totaled 189.

^{148a} For a good survey see Klaue, *Zwei Jahre Rechtsprechung zum Gesetz gegen Wettbewerbsbeschränkungen*, 6 WuW 319 (1960).

¹⁴⁹ Eau de cologne, 4711 v. Johann Maria Farina, 28 Entscheidungen des Bundesgerichtshofes in Zivilsachen [hereinafter cited as BGHZ] 222, 11 NJW 1868 (1958).

which effectuate evasions of statutory prohibitions through uniform conduct, covered recommendations of retail prices, if they were publicized in such a way as to be generally observed by the merchants, as was found by the court below to be the case in the controversy before it. Having arrived at the determination that retail price recommendations of the type in question were *illegal*, the Court addressed itself to the further question of whether violations of the statutory mandate entitled a private party and, in particular, a competitor to relief. It held that the prohibitions of Sections 15, 16, and 38 (2) amounted to a law aiming at the protection of others within the meaning of Restraints of Competition Law, Section 35¹⁵⁰ and that therefore an intentional or negligent contravention constituted a private tort for which a competitor or other injured party could seek redress by way of damages or injunction.¹⁵¹

Another important decision by the High Court involving the Restraints of Competition Law likewise dwelt on the private law ramifications of the Law.¹⁵² It arose out of a discriminatory refusal to an enterprise of membership in a trade association. Such action constitutes an abuse against which the Cartel Authority may proceed upon petition of the aggrieved party by virtue of a special provision in the Law to that effect.¹⁵³ The Court held that the Law, by providing an administrative remedy in the public interest, did not mean to deprive the aggrieved party of redress in the ordinary courts. It held further that the regulation of Section 27 amounted to a law aiming at the protection of the excluded enterprise, thus entitling the latter to mandatory relief in cases of intentional or negligent contravention, pursuant to Section 35 of the Restraints of Competition Law, and not merely in cases of intentional and unethical action, pursuant to Section 826 of the German Civil Code.

A series of pioneering judicial decisions settled basic procedural matters, such as the jurisdiction over, and the proper procedure in, private controversies involving application and interpretation of

¹⁵⁰ See text to notes 135 and 139 *supra*.

¹⁵¹ The court held further that retail price recommendations relating to merchandise sold under trade marks or brands are entitled to registration with the Federal Cartel Office if they are "factually" binding and that, upon such notification, the practice becomes permissible. The court also ruled, upon a cross-complaint for declaratory judgment by defendant, that the mere designation of the specified retail prices as "non-obligatory standard prices" does not remove the ban of the law.

¹⁵² Judgment of BGH of Feb. 25, 1959, 29 BGHZ 344, 12 NJW 880 (1959); 9 WuW 566 (1959).

¹⁵³ Restraints of Competition Law § 27.

the new Law.¹⁵⁴ Others dealt with important questions of substantive law, particularly with difficult aspects of resale price maintenance. Thus the Court of Appeals of Frankfurt rendered a lengthy opinion laying down the various conditions which must be met by a manufacturer's retail price maintenance scheme in order to be enforceable against a price-cutting non-signer,¹⁵⁵ while the Court of Appeals of Munich decided whether a publisher who had established a resale price maintenance system was entitled to discontinue delivery to one of his dealers without running afoul of the statutory prohibition against discrimination by enterprises with dominant market power.¹⁵⁶

The Federal Cartel Office likewise passed on many fundamental questions, for example, on the authorizability of certain cartel types¹⁵⁷ and the invalidation of exclusive-dealing agreements.¹⁵⁸

Of course, the comprehensiveness and novelty of the Law will call for a great deal of judicial or administrative clarification for a long time to come.¹⁵⁹ Some of the decisions mentioned here will be discussed further in connection with the problem of the private law consequences under national legislation of violations of the articles in the E.E.C. Treaty proscribing specified anticompetitive practices by private enterprise.

¹⁵⁴ Judgment of BGH of July 9, 1958, 11 NJW 1395 (1958); Judgment of BGH of Dec. 19, 1958, 12 NJW 575 (1959); Judgment of BGH of June 15, 1959, 30 BGHZ 186, 12 NJW 143 (1959); Judgment of BGH of July 10, 1959, 10 WuW 361 (1960). Judgment of BGH of November 11, 1959, 31 BGHZ 162; Judgment of Oberlandesgericht [hereinafter cited as OLG] Frankfurt of July 17, 1958, 11 NJW 1637 (1958).

¹⁵⁵ Judgment of OLG Frankfurt of July 17, 1958, 9 WuW 361 (1959); 11 NJW 1637 (1958); criticized by Von Gamm, *Die Durchsetzung der Preisbindung im Verletzungsprozess*, 12 NJW 964 (1959). For a recent BGH decision involving the conditions for the enforcement of resale price maintenance systems against signers, see Judgment of BGH of Jan. 20, 1959, 9 WuW 733 (1959).

¹⁵⁶ Judgment of OLG München of Jan. 26, 1959, 12 NJW 943 (1959). For another interesting case involving liability of enterprises possessing dominant market power for discriminatory refusal to deal, see Judgment of OLG Celle of Sept. 1, 1958, 9 WuW 455 (1959).

¹⁵⁷ See the decision of the appeals division authorizing the aggregate-volume rebate-cartel of the wallpaper industry, 9 WuW 455 (1959). For a discussion of current problems in the administration of the Law, see *Bericht des Bundeskartellamtes über seine Tätigkeit im Jahre 1959*, Deutscher Bundestag, 3. Wahlperiode, Drucksache 1795 (1960).

¹⁵⁸ See the Melitta case, 9 WuW 756 (1959). The two annual reports of the Federal Cartel Office, *supra* note 141, contain detailed discussions of the many problems of interpretation that the Office had to face in the administration of the Law.

¹⁵⁹ For a recent important decision by the German Supreme Court involving the concept of a cartel agreement within the meaning of the Restraints of Competition Law § 1 see Judgment of BGH of Oct. 26, 1959, 31 BGHZ 105; for a most important decision clarifying when mere recommendations constitute prohibited circumventions of the Law see Judgment of BGH of Jan. 14, 1960, 13 NJW 723 (1960); 10 WuW 347 (1960).

B. FRANCE

I. DEVELOPMENT OF FRENCH LAW RELATIVE
TO RESTRICTIVE BUSINESS PRACTICES PRIOR TO
THE LEGISLATION OF 1953a. *Period Prior to 1945: The Regime
of Article 419 of the Penal Code*

(1) *Development until World War II.* French law governing restrictive business practices is the product of rather late growth.¹⁶⁰ During the nineteenth and the first part of the twentieth century there existed only limited concern about the curbing of such activities and, at some periods between the two world wars, concentration and cartellization were even fostered officially, especially by administrative action. As a result, the French approach to the protection of competition, whether viewed from a factual or legal aspect, is quite complex and rather difficult to describe. For reasons which will become apparent, the evolution of French law can be divided into three major periods.

The traditional liberalistic tendencies of French decisional law and legal doctrine until comparatively recently made the courts quite hesitant to interfere with business practices. A statute of March 2-17, 1791, had liquidated the medieval restrictions on the access to professional and commercial life and proclaimed freedom of trade.¹⁶¹ The Code Napoléon a little later elevated freedom of

¹⁶⁰ French literature on the law governing cartels and other restrictive business practices has become rather voluminous. Of the copious publications of comparatively recent vintage we mention Reuter, *A propos des ententes industrielles et commerciales*, 15 DROIT SOCIAL 442, 508 (1952); 1953 *ibid.* 1; Mazard, *Prix imposés et prix d'entente*, 16 DROIT SOCIAL 129 (1953); Souleau, *La réglementation des ententes professionnelles dans le décret-loi du 9 août 1953* 16 DROIT SOCIAL 577 (1953); Moreau et Mériqot, *Les ententes professionnelles devant la loi*, in LA DOCUMENTATION FRANÇAISE, ENTENTES ET MONOPOLES DANS LE MONDE, France No. 1736, May 5, 1953 (1953); Barbry and Plaisant, *Libre concurrence et ententes industrielles*, [1954] Dalloz [hereinafter cited as D.] I, 67; Souleau, *Prix*, in ENCYCLOPÉDIE DALLOZ, Répertoire de Droit Criminel 675 (1954); Souleau, *Spéculation Illicite*, in ENCYCLOPÉDIE DALLOZ, Répertoire de Droit Criminel 865 (1954); Plaisant and Lassier, *Les Ententes Industrielles sous forme de Sociétés ou d'Associations*, JURIS-CLASSEUR DES SOCIÉTÉS 178 (1955); Lassier, *La réglementation de la concurrence et des ententes économiques en France: Bilan des trois premières années d'application*, LIGUE INTERNATIONALE CONTRE LA CONCURRENCE DÉLOYALE, Communication No. 43, 14 (1957); Lassier, *Monopoles et Pratiques Commerciales Restrictives*, International Bar Association Conference, Seventh Conference Report, 278, 1958; Castel, *France*, in FRIEDMANN, *ANTI-TRUST LAWS, A COMPARATIVE SYMPOSIUM* 91 (1956); Castel, *Recent trends in compulsory licensing in case of non-use of patents: A comparative analysis*, 36 J. PAT. OFF. SOC'Y 330 No. 5 (1954).

¹⁶¹ For the text see [1789-1830] Sirey, *Lois Ann.* 92.

contract to a cardinal principle of the French legal system.¹⁶² Where these two liberties clashed, the courts were perplexed and floundering.

The chief statutory basis for resolving the dilemma was to be found in Article 419 of the Penal Code of 1810, creating the crime commonly designated as distortion of the price level (*altération des prix*). Otherwise some isolated provisions and general principles developed by the courts had to serve the purpose.

Until its revision in 1926, Article 419 of the Penal Code proscribed and penalized "the raising or depressing of the price level for victuals, merchandise or public securities above or below that which would have flown from natural and untrammelled competition" through two major types of conduct: either (a) "intentional dissemination in the public of false or calumnious facts, the making of offers topping the price asked for by the sellers themselves, or any sort of fraudulent ways or means," or (b) "by combination or coalition among the principal holders of the same type of merchandise or victual, aiming at not selling it or not selling it except at a specified price." In applying this section, especially in respect to combinations, the courts vacillated from period to period, reflecting the changing moods of the times.¹⁶³ At first the courts favored a broad construction. Thus the statutory terms "victuals" and "merchandise" were held to include transportation,¹⁶⁴ and the actual raising or lowering of the price level was not considered critical if the purpose of the combination was the attainment of such results.¹⁶⁵ The passage of the law of 1884, establishing full freedom of association,¹⁶⁶ was deemed to be a legislative recogni-

¹⁶² CODE CIVIL art. 1134.

¹⁶³ For a detailed analysis see Moreau in Moreau et Mérigot, *op. cit. supra* note 160, at 38.

¹⁶⁴ The two leading cases in that respect involved a combination of two stagecoach companies which attempted to undersell their competitors, *Messageries Royales et Générales c. Guérin*, Cass. Crim. Div. 1836, [1836] Sirey, Jur. 882; *Messageries Françaises c. Messageries Royales et Générales*, Cass. Crim. Div. 1839, [1839] Sirey, Jur. 722.

¹⁶⁵ As early as 1850 the Supreme Court of France declared in a case involving an agreement between local merchants and ship captains stipulating for discriminatory freight charges against outsiders "that in a commercial matter it is not necessary that the decision which finds the perpetration of a coalition declare expressly that the result of the combination was a raising or lowering of the price level of goods so long as the whole of the decision is to that effect." *Gombaud c. Petit*, [1850]. D. I, 212.

¹⁶⁶ [1884] D. IV, 129. Arts. 2 & 3 thereof provided: "The trade unions or associations, even of more than twenty persons exercising the same profession, similar trades or connected professions concurring in the manufacture of specified products, may be established freely without governmental authorization." "The trade unions have as their exclusive object the study and the protection of economic, industrial, commercial and agricultural interests."

tion of the principle that trade associations and combinations for economic purposes were not illegal per se and resulted in, or at least strengthened, a doctrinal and decisional trend of differentiating between "good" and "bad" cartels.¹⁶⁷ Combinations of manufacturers were found not to be illicit even where they engaged in price-fixing, division of markets, or restriction of production,¹⁶⁸ and the French Supreme Court went along in sanctioning such holdings.¹⁶⁹ As a consequence the provisions of Article 419 of the Penal Code appeared more and more an anachronism, and a revision of the law relative to status of combinations was felt to be in order. In 1926 an amendment became reality,¹⁷⁰ and the pertinent section was overhauled. In its new and current form, Article 419 penalized the effectuation of, or the attempt to effectuate, an artificial rise or fall of the price level for victuals, merchandise, or public or private securities (a) by specified or other fraudulent maneuvers or (b) by individual or concerted action on the market with the purpose of obtaining a profit which would not result from the natural play of demand and supply.¹⁷¹ Actually, the new law, apart from closing certain gaps relative to attempts and individual action, engendered little change. Combinations were held illegal only in infrequent and comparatively minor cases of local character which, as Professor Reuter has so aptly put it, smacked of a setting borrowed from a Balzac novel.¹⁷²

¹⁶⁷ Illustrative of and analyzing this trend are especially the long annotation by Professor Percerou to a decision of May 3, 1911 by the French Supreme Court in *Gaillard et autres c. La Renaissance*, [1912] D. I, 33, 39, and the opinion by Justice Michel-Jaffard in the same case, *id.* at 40. This case involved a combination of plate glass cutters and polishers providing for cooperation in production and standardization of pricing practices.

¹⁶⁸ See, for instance, the decision of the Appellate Court of Nancy of 1902 in the matter of the *Comptoir Métallurgique de Longwy*, involving a combination of the principal foundries in Lorraine providing for common purchases, production quotas, fixed sales prices, etc., discussed by Moreau in *Moreau et Mériquot, op. cit. supra* note 160, at 41, and by Plaisant and Lassier, *op. cit. supra* note 160, at 9 and 13.

¹⁶⁹ *E.g.*, in the case of *Gaillard et autres c. La Renaissance, supra* note 167.

¹⁷⁰ For the legislative history see Moreau in *Moreau et Mériquot, op. cit. supra* note 160, at 42.

¹⁷¹ "Anyone (1) who by means of false or calumnious facts disseminated intentionally in the public, or by offers thrown on the market with the purpose of disturbing the quotations, or by offers topping the prices demanded by the sellers themselves or by whatever other fraudulent ways and means; or (2) who by perpetrating or attempting to perpetrate an action on the market, whether individually or in concert or coalition and with the purpose of securing a profit not resulting from the natural play of supply and demand, directly or through a middleman effectuates, or attempts to effectuate, an artificial rise or fall of the price for victuals, wares, or public or private securities, shall be punished with imprisonment . . . or a fine. . . ."

¹⁷² Reuter, *A propos des ententes industrielles et commerciales*, 16 DROIT SOCIAL 1 at 4 (1953).

Where a combination is illicit because it aims at, or results in, excessive profits or the elimination of competitors, the participants are not only subject to criminal prosecution but may be held liable for damages by the injured competitor.¹⁷³ Moreover, dissatisfied parties may have the agreement annulled by civil action¹⁷⁴ or assert its invalidity as a defense if the other members of the combination attempt to collect stipulated damages for breach thereof.¹⁷⁵

The economic crisis of the thirties and the impact of World War II resulted in a further strengthening of the status and role of the cartels.

In France, as in most other countries, there was a widespread belief that the great depression was caused by over-production and consequent disorganization of the market and that the cure was to be found in a strict self-regulation by the various branches of industry and commerce. As a result, the government between 1935 and 1938 proceeded to foster or even require cartellization in a number of industries and trades and obtained power to do so in a number of other instances.¹⁷⁶ The sugar industry,¹⁷⁷ shoe manufacturing,¹⁷⁸ high sea fisheries,¹⁷⁹ the potassium industry,¹⁸⁰ and the export trade¹⁸¹ are perhaps the most important instances of such action.

(2) *World War II*. World War II brought a complete transition to a controlled economy in the form of the authoritarian corporative state¹⁸² which lasted until the establishment of the Fourth Republic and was formally terminated by a statute of

¹⁷³ See, e.g., *Messageries Royales et Générales c. Guérin*, *supra* note 164, holding that art. 419 permits the institution of a prosecution by the injured competitor coupled with the recovery of damages.

¹⁷⁴ See, e.g., *Gombaud c. Petit*, *supra* note 165.

¹⁷⁵ See, e.g., *Gaillard et autres c. La Renaissance*, *supra* note 167.

¹⁷⁶ For a detailed discussion of this phase of French legislation see Moreau in Moreau et Mérigot, *op. cit. supra* note 160, at 63-75.

¹⁷⁷ Decrees of Aug. 8, 1935 and Oct. 30, 1935, [1935] D. IV, 252, 533.

¹⁷⁸ Law of Mar. 22, 1936, implemented by regulation of Mar. 26, 1936, [1936] D. IV, 155, 160 and Law of Apr. 7, 1936, [1936] D. IV, 160.

¹⁷⁹ Decree and regulation of Jan. 14, 1936, discussed by Moreau in Moreau et Mérigot, *op. cit. supra* note 160, at 67.

¹⁸⁰ Law of Jan. 23, 1937, [1938] D. IV, 156.

¹⁸¹ Decree of May 24, 1938, [1938] D. IV, 259, discussed by Teitgen, in Note, 1 DROIT SOCIAL 237 (1938).

¹⁸² The two main legislative enactments establishing the framework for this action were the Law of July 11, 1938 regarding the organization of the nation in time of war, [1939] D. IV, 209 (especially arts. 46 and 49), and the Law of Aug. 16, 1940, regarding the provisional organization of industrial production, [1940] D. IV, 253; see Noyelle, *L'économie dirigée selon la loi du 16 août 1940*, 7 COLLECTION DROIT SOCIAL 4 (1941); Teitgen, *L'organisation provisoire de la production industrielle et les principes du droit public français*, 9 COLLECTION DROIT SOCIAL 2 (1941); Personnaz, *Les Groupements d'importation et de répartition*, 18 COLLECTION DROIT SOCIAL 23 (1943).

1946.¹⁸³ Yet, there still survived numerous semi-official trade associations which had been formed during the crises and wartimes and which appeared to be ripe for liquidation. This was accomplished by a decree of 1949 and a regulation of 1950 implementing it.¹⁸⁴ However, this action failed to make a clean sweep. The government retained certain compulsory combinations and sub-combinations with official functions, especially in the steel industry and the coal import trade, and, as a consequence, found itself involved eventually in a protracted controversy with the High Authority of the European Coal and Steel Community.¹⁸⁵

¹⁸³ Law No. 46-827 of Apr. 26, 1946, effectuating dissolution of the professional organisms, [1946] D. IV, 195.

¹⁸⁴ Decree No. 49-1236, modifying the conditions of liquidation of certain organisms of the para-administrative sector, JOURNAL OFFICIEL DE LA RÉPUBLIQUE FRANÇAISE [hereinafter cited as J.O.] Sept. 12, 1949, 9278 (1949); regulation of Jan. 11, 1950 of the Minister for Finances and Economic Affairs, specifying the organisms affected by the decree 49-1236, J.O. Jan. 11, 1950, 395 (1950).

¹⁸⁵ For details see European Coal and Steel Community, High Authority, FOURTH GENERAL REPORT, 147 (1956); FIFTH GENERAL REPORT, 130, 157 (1957); SIXTH GENERAL REPORT II, 93 (1958). The facts, as gathered from these reports and inquiries by the author, are as follows: In November 1944 the shortage of both coal and foreign currency prompted the organization of a private non-profit corporation, styled A.T.I.C. (Association technique de l'importation charbonnière), which included as members the major importer-consumers and representatives of the professionally recognized importer-distributors, the latter being organized in two trade associations called, respectively, G.P.I.R. (Groupement professionnel des importeurs revendeurs) and G.P.I.R.T. (Groupement professionnel des importeurs revendeurs par voie terrestre). Subsequently, in 1944 and early in 1945, the Ministry of Industrial Production charged A.T.I.C. with certain public functions. Its activities were placed under the supervision of a government commissioner and the State was entitled to nominate the president of the corporation. The nationalization of the French coal mines by the Law of May 17, 1946 ([1946] D. IV, 230) entailed a further strengthening of the prerogatives and functions of A.T.I.C. Meanwhile the government also had undertaken a re-definition of the functions of the various cartel-agencies of the steel industry by regulation of June 28, 1947 (J.O. 6234). A corporation called C.P.S. (Comptoir français des produits sidérurgiques) was recognized as the joint sales agency of the steel industry, in charge of the allocation of orders, as well as the delivery terms. Another corporation called O.R.C.I.S. (Office de réparation des combustibles pour l'industrie sidérurgique) was placed in charge of the coal industry's procurement, having a monopoly with respect to all plants using at least 100 tons per month. A.T.I.C. henceforth was composed of the two importer-distributor organizations mentioned above, and a few of the largest consumers, such as O.R.C.I.S., the Electricité de France and the Société Nationale des Chemins de Fer. By Decree No. 57-46 of January 24, 1948 (J.O. 791) it was established that both the purchase and transport, until delivery to its destination, of foreign coal could not be effectuated except through an association of importers, the reciprocal obligation to be regulated by agreement between the government and the association; and in consequence of this provision A.T.I.C. on April 7, 1948 was placed in charge of these functions. In 1952 in order to conform with the French law of 1952 regarding price-fixing and in anticipation of the impending establishment of the European common market for steel, the steel industry changed the status of the C.P.S. into a trade association, with mainly statistical functions. The structure and functions of A.T.I.C. and its components, however, remained unchanged. As a result the High Authority felt that this setup in the French coal industry was inconsistent with the Treaty and entered into protracted negotiations with the French government. The French govern-

b. *The Period from 1945-1952: The Advent of "Acts Assimilated to Illegal Pricing"*

The recoil from the system of the corporative state launched by the Vichy government brought a return to the free market economy. Nevertheless, this change-over was slow, beset with difficulties, and by no means complete. Certain sectors of the French economy, especially in the fields of banking, insurance, production and distribution of electricity and gas, and coal mining were withdrawn partially or totally from private enterprise by means of the famous nationalization decrees of 1945 and 1946.¹⁸⁶ In the remaining areas retention of price control remained unavoidable at first. The war, of course, had necessitated in France, as elsewhere, the introduction of rationing and price controls. The latter was accomplished by a series of price freezing decrees which culminated in the codification of October 21, 1940.¹⁸⁷ The restoration of the Free French government was followed in 1945 by the enactment of a new comprehensive price control ordinance¹⁸⁸ which reproduced a great portion of the provisions of the prior legislation.

The Ordinance of June 1945, which since its passage has been the object of a steady stream of amendments, defines and penalizes, in Article 36, a lengthy array of types of action labeled as "illicit pricing practices." This catalogue is followed, in the subsequent article, by the enumeration of additional categories of prohibited conduct, lumped together under the common designation of "offenses assimilated to illicit pricing practices." The latter list in-

ment was willing to, and did, deprive O.R.C.I.S. of its legal coal purchase monopoly for the steel industry and opened membership in G.T.I.R. and G.P.I.R.T. to all authorized importers. Moreover, by Decree No. 57-46 of January 14, 1957 (Dall. Bull. Lég. 72) it changed the position of A.T.I.C. with respect to coal purchases in the countries belonging to the European Coal and Steel Community to that of a broker or agent, free from administrative veto or instruction. As this action still required French buyers to procure non-French Community coal through the state-controlled cartel agency and to purchase from non-French dealers in the Community through the medium of authorized French dealers, the High Authority, on December 18, 1957, issued a decision finding that such regulation was incompatible with the duties under the Treaty. The French Government asked for review and annulment of this decision by complaint filed on February 26, 1958 (7 Journ. Off. de la Communauté Européenne du Charbon et de l'Acier 151 (1958)).

¹⁸⁶ See 1 HAMEL AND LAGARDE, *TRAITÉ DE DROIT COMMERCIAL* 37, 887 (1954) and the Laws of Dec. 2, 1945 (banking), April 25, 1946 (insurance), April 8, 1946 (gas and electricity) and May 17, 1946 (coal mining).

¹⁸⁷ Law for the modification, completion and consolidation of price legislation, [1940] Sirey, Lois, Décrets etc. 1654.

¹⁸⁸ Ordinance No. 45-1483 of June 30, 1945, [1945] Sirey, Lois Ann. 1898.

cludes¹⁸⁹ a variety of restrictive or discriminatory business practices. In the course of time it has been considerably expanded and has come to constitute the actual core of French legislation safeguarding economic competition.¹⁹⁰

Article 37 of the Ordinance of June 1945, as originally enacted, proscribed three categories of restrictive business practices, committable by dealers, manufacturers, or artisans: ¹⁹¹ (a) the refusal to sell disposable stock-in-trade or to render feasible services; ¹⁹² (b) arbitrary discrimination in the hours for the sale of different kinds of merchandise or for the rendition of different types of services; ¹⁹³ and (c) tie-in clauses or quantity restrictions.¹⁹⁴ In addition, the ordinance specified a general crime of speculative hoarding, committable either by persons other than merchants, artisans, or growers with respect to any kind of commodity, or by mer-

¹⁸⁹ Some of the infractions classified as "offenses assimilated to illicit pricing practices" cannot be considered as restrictive or discriminatory business practices, but merely as actions apt or calculated to thwart the maintenance and enforcement of price controls. Thus art. 37(1)(d) prohibits the failure to produce certain business records promptly upon request by the authorities. Conversely, some of the actions, proscribed under the rubric of illicit pricing practices may perhaps under certain circumstances assume a restrictive flavor, particularly the offense specified in art. 36(8) and styled as intervention of a new (*i.e.*, noncustomary) middleman. For a discussion of the elements of this type of infraction see Souleau, *Prix*, *ENCYCLOPÉDIE DALLOZ*, *Répertoire de Droit Criminel* 675 at 680 (1954).

¹⁹⁰ As Professor Reuter has pointed out and illustrated so lucidly, the French price control system originally was conceived as an autonomous arrangement designed to determine ceiling prices. Yet quickly and to a steadily increasing extent it had to concern itself with the mechanics of the competitive process and to combat and proscribe certain restrictive practices while, on the other hand, its administration on occasion necessitated resort to "dirigistic" and concentrative techniques, 16 *DROIT SOCIAL* 1, 10 (1953).

¹⁹¹ Actually the three categories specified were incorporated from a prior decree of January 30, 1940, [1940] *Sirey*, *Lois Ann.* 1394.

¹⁹² Art. 37(1)(a): "To withhold products destined for sale by refusing to fill orders of purchasers within the limits of disposability or to refuse the filling of orders for the rendition of services within the limits of available means, so long as such orders do not possess an abnormal character and the sale of these products or the rendition of these services are not prohibited by special regulation or subject to conditions which are not met."

¹⁹³ Art. 37(1)(b): "Absent the applicability of any special regulation, to restrict the sale of certain products or the rendition of certain services to certain hours of the day, although the establishments or shops involved remain open for the sale of other products or the rendition of other services."

¹⁹⁴ Art. 37(1)(c): "Absent the applicability of any special regulation, to condition the sale of any product or the rendition of any service upon either the simultaneous purchase of other products or the purchase of a required quantity or the rendition of another service." It may be mentioned in this connection that exclusive dealing contracts (as distinguished from tying clauses) were restricted in duration to a period of ten years by a statute of October 14, 1943, [1943] *Sirey*, *Lois Ann.* 1378, cf. Hémar, *Les Contrats commerciaux* in ESCARRA ET RAULT, *TRAITÉ THÉORIQUE ET PRATIQUE DE DROIT COMMERCIAL* 66 (1953).

chants, artisans, or growers with respect to commodities or goods foreign to their authorized trade or occupation.¹⁹⁵

In 1946¹⁹⁶ this list of offenses assimilated to illicit pricing practices was lengthened by inclusion of a prohibition against individual as well as concerted or collective action aiming at the thwarting of price control through threats or effectuation of withdrawal from activity as a dealer, manufacturer, or artisan. In 1947 further additions to and modifications of illicit pricing practices and offenses assimilated thereto were made. Thus, tying of an exchange of goods or services, outside of personal or family needs, to the sale of products, the rendition of services, or the offer of such sale or rendition was declared to be a further illicit pricing practice.¹⁹⁷ Moreover, the definition of the offense of speculative hoarding of inventory as committable by growers, manufacturers, or merchants were identified and expanded and the catalogue of Article 37 was lengthened to conform to that change.

In 1952, at a time when the enactment of general cartel legislation was a much debated issue, the government decided to propose immediate and separate measures against concerted price-fixing. The result was the passage of Law No. 52-835 of July 18, 1952, which added to the catalogue of offenses assimilated to illicit pricing practices in Article 37 of the Ordinance of 1945 a new clause to that effect. It prohibited the imposition and maintenance of minimum prices by means of organized or collective action, except with respect to articles protected by a trademark or within the limits of governmental dispensation. The Law provided specifically that it should cease to be operative upon the enactment of a general law on the subject of business combinations.¹⁹⁸

In addition, the return of a relative abundance of goods necessitated the outlawing of a business practice which was deemed to permit large scale suppliers an undue advantage over their small competitors: the sale with gratuities. A statute of March 20, 1951, prohibited and penalized sales coupled with the distribution of gratuities of all sorts such as other merchandise, coupons, etc.¹⁹⁹

¹⁹⁵ Ordin. of June 30, 1945, arts. 37(2) and 45 in conjunction with arts. 41-44.

¹⁹⁶ Law No. 46-1024 of May 14, 1946, [1946] D. IV, 224.

¹⁹⁷ Law No. 47-587 of April 4, 1947, art. 1, [1947] D. IV, 148 amending art. 36 of the Ordinance No. 45-1483 of June 30, 1945.

¹⁹⁸ Law No. 52-835 of July 18, 1952 [1952] D. IV, 259. For a detailed discussion of its history and significance see Mazard, *Prix imposés et prix d'entente*, 16 DROIT SOCIAL 129 (1953).

¹⁹⁹ Cf. Hémard, *Les ventes avec primes*, 11 REVUE TRIM. DE DROIT COMMERCIAL 473

2. THE PERIOD SINCE 1953: CARTEL LEGISLATION OF 1953 AND ITS SEQUELS

The year 1953 brought a special and more general regulation of the activities of combinations of enterprises. It constituted the climax of and, in a real sense, the anticlimax to, the long series of attempts during the preceding thirty years to obtain comprehensive parliamentary action determining the legal status of cartels and similar combinations.²⁰⁰ The sharp conflict between the two chambers about the scope and content of such legislation early in 1953 prompted the Laniel government to forego reliance on parliamentary action and to resolve the impasse by using the emergency powers in the economic field conferred upon the government by Law No. 53-611 of July 11, 1953, for economic and financial rehabilitation.²⁰¹ The result of this decision was the passage of Decree No. 53-704 of August 9, 1953, relative to the maintenance or re-establishment of free competition in industry and commerce.²⁰² Formally this Decree added a new section entitled "Maintenance of free competition" to the Price Control Ordinance of 1945 (composed of Articles 59 *bis*, *ter*, and *quater*) and amended Article 37 thereof which (as discussed above) defines and punishes offenses assimilated to illegal pricing practices.

The new Article 59 *bis* prohibits, with qualifications subsequently specified, "all concerted actions, agreements, express or implied understandings, or combinations under whatever form or for whatever reasons, that have as objective or may have as result the restraint of the full exercise of competition by hindering the lowering of costs or sales prices or by facilitating an artificial rise of the prices."

Article 59 *ter*, however, exempts two categories of cases from this prohibition: (a) those in which the otherwise prohibited action was taken in compliance with a statute or regulation, and (b)

(1958); Hémard, *Les contrats commerciaux* in ESCARRA ET RAULT, *TRAITÉ THÉORIQUE ET PRATIQUE DE DROIT COMMERCIAL* 63 (1953).

²⁰⁰ For a detailed discussion of the various French projects for a legislative determination of the status of monopolies and combinations of enterprises, see Moreau in Moreau et Mériqot, *Les ententes professionnelles devant la loi*, 93, 151 (LA DOCUMENTATION FRANÇAISE, RECUEILS ET MONOGRAPHIES, No. 21, 1953).

²⁰¹ See Souleau, *La réglementation des ententes professionnelles dans le décret-loi du 9 août 1953*, 16 DROIT SOCIAL 577 (1953); Poinso-Chapuis, *Le contrôle des ententes professionnelles et le problème de la liberté des ententes*, 16 DROIT SOCIAL 576 (1953); Barbry and Plaisant, *Libre concurrence et ententes industrielles*, [1954] D. I, 67; Delpech, *Ententes Professionnelles*, in I Dalloz, *Répertoire de Droit Commercial et des Sociétés* 783, 792 (1956). For the Law of July 11, 1953 see [1953] Dall. Bull. Lég. 511.

²⁰² [1953] Dall. Bull. Lég. 587.

those in which the actions could be justified as resulting in an improvement or extension of the markets for the production or as assuring the development of the economic process through rationalization and specialization.

Agreements and undertakings thus proscribed are declared void as a matter of private law, but the participants are barred from invoking the nullity against third parties.²⁰³ In addition, engaging, or inducing to engage, in prohibited combinations was specifically included in the catalogue of offenses assimilated to illicit pricing practices.²⁰⁴

In order to assure the proper application and enforcement of the new regime, the Decree established a special administrative agency entitled Commission Technique des Ententes and composed of 12 members, of whom six were to be chosen from high-ranking judicial or administrative officers, four from business organizations, and two from the National Committee for Productivity.²⁰⁵ This body is given investigatory powers and charged with the responsibility of ascertaining whether or not violations of the terms of the ordinance have occurred and to initiate prosecution in case of such finding. Further implementation regarding the proceedings of and before the Commission was left to an administrative regulation which was issued on January 27, 1954.²⁰⁶ Moreover, by Circular of March 31, 1954,²⁰⁷ the Ministry of Economic Affairs issued a detailed commentary explaining and construing the cartel provisions of the Decree of 1953. This Circular, though not possessing the force of law, has had decisive effect on the subsequent practice.

In addition to the new discipline of cartel activities the Decree of 1953 amended some of the existing prohibitions of restrictive practices. Thus, the offense constituted by a refusal to deal was slightly re-phrased and enlarged by a new interdiction of habitual discriminatory price increases not justified by cost differentials.²⁰⁸ Similarly, the scope of the prohibition against the main-

²⁰³ Art. 59 bis. paras. 2 and 3.

²⁰⁴ Art. 37(3), as revised.

²⁰⁵ Art. 59 quater.

²⁰⁶ Decree No. 54-97 of Jan. 27, 1954, [1954] D. IV, 86. For a discussion of the procedure of the commission see Durand, *La commission technique des ententes*, 23 DROIT SOCIAL 65 (1960).

²⁰⁷ Secrétariat d'Etat aux Affaires Economiques, Direction Générale des Prix et des Enquêtes Economiques, Circulaire No. 65, entitled Instruction portant commentaire des dispositions du décret no. 53-704 du 9 août 1953 relatives aux ententes professionnelles.

²⁰⁸ The new definition of the offense (art. 37(1)(a)) reads as follows: "To refuse the filling of orders by purchasers of products or for the rendition of services within the limits of feasibility, so long as these orders do not present an abnormal character,

tenance of minimum prices was expanded in several respects and the exceptions clarified.²⁰⁹ It should be noted, in particular, that now all vertical fixing of minimum prices, whether by an individual manufacturer employing the proscribed methods or by collective action, are condemned by the law. These two categories of infractions and their various elements formed the content of an elaborate administrative commentary, published by Circular of February 15, 1954.²¹⁰

In 1955, apart from a further addition (concerning formalities to be observed in sales on credit and installment sales) to the catalogue of offenses assimilated to illicit pricing practices,²¹¹ the government issued an important decree which again fostered and strengthened cartelization.²¹² By the terms of this enactment, government authorization could be obtained for the formation of enterprise combinations, with national or regional scope, for the purpose of plant rationalization or conversion. In addition, such combinations were enabled to obtain direct subsidies of various types, and contributions to them by the member enterprises were declared to be tax deductible.

In 1958 the Council of State held that the Laniel government had lacked the powers for the imposition of penal sanctions for engaging in restrictive combinations.²¹³ As a result, the provisions of the Decree of 1953 had to be re-enacted. This step was taken

emanate from good faith offerers and the sale of the products or the rendition of services are not prohibited by law or administrative regulation, as well as to engage habitually in discriminatory price increases which are not justified by cost differentials." For a detailed comparison between the new and the old elements of the offense, see Barbry and Plaisant, *Libre concurrence et ententes industrielles*, [1954] D. I, 67, 70.

²⁰⁹ The new definition of the offense (art. 37(4)) has the following form: "[It is unlawful] for any person to confer, maintain or impose a minimum character upon the price of products and rendition of services or upon the commercial mark-ups, either by means of tariffs or price lists or by virtue of combinations, whatever may be their nature or form.

"This subsection does not apply in cases where the products or services are the object of a dispensation granted by joint order of the Minister for Economic Affairs, the Minister of Commerce and the Minister having a particular interest in the matter. This dispensation, which in any event must be of limited duration, may be granted particularly in view of the novelty of the product or service; of the exclusiveness derived from a patent, a license of exploitation or the deposit of a utility model; of the need for a booklet of charges signifying warranty of quality and specification of condition; or of an advertising campaign for the purpose of launching."

²¹⁰ For the complete text see [1954] D. IV, 96.

²¹¹ Decree No. 55-585 of May 20, 1955, [1955] Dall. Bull. Lég. 559.

²¹² Decree No. 55-877 of June 30, 1955, [1955] Dall. Bull. Lég. 740, implemented by Decree No. 55-1369, of October 18, 1955 [1955] Dall. Bull. Lég. 1012.

²¹³ Syndicat des grossistes en matériel électrique de la région de Provence et autres, Conseil d'Etat June 18, 1958, [1958] Rec. Cons. d'Etat, 358 (1958), Juris-Classeur Périodique [hereinafter cited as Juris-Class. Pér.] No. 10727. As a result, convictions

by Decree No. 58-545 of June 24, 1958.²¹⁴ While in most respects it was merely a textual reproduction of the prior decree, it made some minor changes in the composition and procedure of the Commission Technique des Ententes and inserted some additions in the definitions of the offenses constituted by a "refusal to deal" or by discriminatory price increases. The former crime is now committed only by a failure to fill normal and bona fide orders within the limits of feasibility *and under conditions conforming with commercial usages*. The latter infraction now consists in the habitual resort to discriminatory *sales* terms or price increases not justified by corresponding augmentations in the costs of *procurement or service*.²¹⁵

A decree of August 17, 1959,²¹⁶ introduced some further modifications in the size and composition of the Commission Technique des Ententes,²¹⁷ eliminated some unnecessary formalities in the procedure and, above all, provided for the publication of annual reports including the decisions of the Minister and the opinions of the Commission.

3. THE RESULTING CURRENT PICTURE

a. General Summary

From the foregoing discussion of the legislative developments in France, it can be concluded that at least one line of her economic and juristic policies has taken the course of protecting workable and working competition against restraints and impairments flowing from an untrammelled adherence to the principle of freedom of contract. Legislative enactments and decisional developments have combined in the suppression of certain agreements, whether of the horizontal or the vertical type, as restrictive, discriminatory, or abusive. On the other hand, it cannot be said that there exists a uniform and clear-cut policy against combinations in restraint of

under the pertinent sections of the decree of 1953 had to be set aside, Lissac c. Daire, Cour d'Appel de Paris, (9^e ch. corr.) Oct. 29, 1958, [1958] Juris-Class. Pér. No. 10864; De Lassus de Saint Geniès, Trib. corr. Seine, (12^e ch.) Oct. 28, 1958, [1958] Juris-Class. Pér. No. 10880.

²¹⁴ Decree No. 58-545, [1958] Dall. Bull. Lég. 447. Its legality is discussed by Auby, *Limitations apportées à l'exercice, par le Gouvernement, de pouvoirs spéciaux: A propos de la légalité du décret du 24 juin 1958 modifiant certaines dispositions de l'ordonnance no. 45-1483 du 30 juin 1945*, [1960] D. I, 46.

²¹⁵ The italicized words are the amendments.

²¹⁶ Decree No. 59-1004, [1959] D. IV, 574.

²¹⁷ The commission is now composed of fourteen members. Its president is a Councillor of State, a justice of the Court of Cassation, or a senior judge of the Court of Accounts; five members are selected from the members of the Council of State or the judiciary; six members are chosen by reason of their professional competency; and two members are elected because of their economic expertise.

trade or monopolization. To be sure, cartels and similar combinations have been subjected to an ever-increasing control and curbing of manifest abuses. But they still enjoy a wide area of toleration and legitimate action and, above that, there are many conditions or sectors of the economy in which the government considers combinations and their discipline as salutary and in the public interest with the attendant grant of privileges and subsidies.²¹⁸ As a result, the situation is not free from paradoxes and dilemmas.

As a matter of positive law, the main statutory sources for the suppression of restrictive, discriminatory, or abusive business practices are to be found in Article 419 of the Penal Code and Articles 37 and 59 *bis, ter* and *quater* of the Price Control Ordinance of 1945, as amended. Conversely, legislative bases for the fostering or aiding of combinations are widely dispersed and quite obscure.

b. *Currently Existing Prohibitions and Their Interrelation*

(1) *Article 419 of the Penal Code and the general principles of law.* Article 419 of the Penal Code and the general principles of law based upon it, as well as upon the proclamation of the freedom of trade, still serve as the ultimate palliatives against unabashed and abusive restraints of competition and are invoked by the courts, with increased liberality, to vindicate the interests of consumers or obstinate competitors or to relieve unwilling participants.

Thus, the Court of Cassation not long ago upheld a judgment by the Court of Appeals of Paris which condemned the blacklisting of a perfume store owner by the trade association of perfume manufacturers on account of violations of his resale price maintenance obligations and awarded damages to the boycotted plaintiff.²¹⁹ Likewise, the courts have held invalid and unenforceable agreements by bakeries prohibiting supplying of grocery stores and other retailers²²⁰ or home delivery services.²²¹

²¹⁸ For a recent forceful advocacy of the necessity and advantages of cartels in manufacture or export trade by a government official charged with economic administration see Teissèdre, *Les groupements d'exportateurs: Effort d'adaptation au Marché Commun*, 1958 REVUE DU MARCHÉ COMMUN 404 (No. 8); for a more resigned appraisal see Mérigot, *Les données économiques du problème de la législation des ententes en France*, in Moreau et Mérigot, *Les ententes professionnelles devant la loi*, *op. cit. supra* note 160, at 7.

²¹⁹ *Groupeement des parfumeurs de marques réglementées c. Berthier*, Cour de Cassation, (ch. civ.) May 9, 1957, [1957] D. II, 665, with note by Esmein, upholding Cour d'Appel de Paris, June 23, 1953, [1954] D. II, 366, with note by Léauté.

²²⁰ *Boulangers d'Aix-les-Bains c. Mallen et Guichet*, Cour d'Appel de Chambéry, May 26, 1953, [1954] D. II, 365.

²²¹ *Vattement c. Amette*, Cour d'Appel de Rouen, (2° ch.) Nov. 14, 1957, [1958] D.

However, the main sources of judicial or administrative action are now the detailed provisions codified in the Price Control Ordinance of 1945, as amended, especially in Articles 37(1)-(5) and 59 *bis* and *ter*.

(2) *Particular restrictive practices prohibited by Ordinance No. 45-1483*. As has been discussed in the previous section in connection with the development of French law relative to the protection of competition, Ordinance No. 45-1483, as currently applicable, contains in Article 37 a catalogue of specifically proscribed restrictive practices.²²² This list has been lengthened and modified in details by a series of enactments passed since the original enactment in 1945, especially by Decree No. 53-705 for the preservation or re-establishment of free commercial and industrial competition and Decree No. 58-545, re-enacting it with slight modifications. The most important of these prohibitions are those against (a) discriminatory refusal to deal (Article 37(1)(a) first branch);²²³ (b) habitual discriminatory price increase (Article 37(1)(a) second branch);²²⁴ (c) discriminatory restriction of store hours with respect to particular commodities or services (Article 37(1)(b));²²⁵ (d) tie-ins (Article 37(1)(c));²²⁶ and (e) fixing of minimum resale prices (Article 37(4)).²²⁷

The list shows that French law contains no special provision against exclusive dealing (requirement) contracts *as such*, apart

III, 138; Andouin et autres c. Fortin, Cour d'Appel de Poitiers, July 2, 1954 [1954] D. II, 771.

²²² As mentioned before, the decree penalizes also other pricing practices which, without being restrictive, are deemed to be in violation of the public price controls. Thus, art. 36(9) penalizes sales or offers of sales at conditions constituting disguised additions to the quoted price, construed in *Min. Public c. G.*, Trib. corr. Alès, Oct. 26, 1956 [1956] *Juris-Class. Pér.* No. 9593; art. 36(13), mentioned *supra* in the text at note 197, penalizes the coupling of sales and service contracts with the trading of other goods or services except for the satisfaction of personal or family needs. The latter interdiction supplements the general prohibition of tie-ins, made by art. 37(1)(c), *supra* note 193.

²²³ See *supra* note 208.

²²⁴ See *supra* note 208.

²²⁵ See *supra* note 193.

²²⁶ See *supra* note 194. In addition to the proscription of express tying contracts, French law specifically prohibits and penalizes hidden tie-ins by means of stamps for or outright gifts of "free" merchandise to purchasers. A statute to the effect was passed in 1951, Law. No. 51-356 of March 20, 1951, [1951] D. IV, 89, and supplemented by the Interpretative Governmental Decree No. 51-1178 of Sept. 19, 1951, [1951] D. IV, 366. The latter was invalidated in part by the Council of State in 1956, *Société Approvisionnement Livraison, Vente et Publicité, C. E.* June 1, 1956, *Rec. Cons. d'Etat* 216 [1956] *Juris-Class. Pér.* No. 9749, with note by Hémard. For a recent Court of Cassation decision applying the statute see *Borocco et autres, Cour de Cassation (Ch. crim.)* Nov. 12, 1957, [1958] D. II, 271, with note by Hémard.

²²⁷ See *supra* note 209.

from the above-mentioned statute of 1943,²²⁸ which restricts their duration to ten years. Accordingly, it has been held that an agreement whereby a retailer has obligated himself vis-à-vis a manufacturer to procure all his requirements of a particular class of merchandise from the latter is unaffected by the Decree of 1953 and enforceable.²²⁹ Conversely, the courts likewise have held that grants of exclusive territorial franchises for the sale of particular products, stipulated between a manufacturer and certain dealers, do not constitute an undue discriminatory refusal to sell within the meaning of the Decree of 1953 and that they are enforceable, by quasi-delictual action, even against third parties disregarding such arrangement.²³⁰ Where, however, the producer or wholesaler has not established a system of exclusive distributorships, his failure to supply customers without legitimate cause falls within the notion of a discriminatory refusal to sell, proscribed by the Decree of 1958.²³¹ The interpretative Circular of February 15, 1954, mentioned above, is in accord with these results.²³²

The aforementioned prohibition against the fixing of minimum resale prices or minimum mark-ups is very broad in its scope. It clearly applies to all types of vertical arrangements, whether by means of formal or informal, express or tacit, understandings or by means of price lists or schedules and regardless of whether they emanate from a single person or combination.²³³ The notion of minimum prices and mark-ups includes the cases where no variations are permitted.²³⁴ Exemptions may be granted by orders of the appropriate Ministers. The decree lists as proper instances de-

²²⁸ See *supra* note 194.

²²⁹ *Epoux Ruer c. Soc. des Grandes Brasseries de Charmes*, Cour d'Appel de Colmar of Nov. 5, 1958, [1959] D. II, 183.

²³⁰ *Soc. Guerlain c. Morand*, Cour d'Appel d'Aix (2^e ch.), Oct. 14, 1958, [1959] *Juris-Class. Pér.* No. 10924; *Editions G. P. c. Brunel "Le Crayon d'Or,"* Cour d'Appel de Bordeaux (2^e ch.), Dec. 10, 1958, [1958] *Juris-Class. Pér.* No. 10933; *Soc. Guerlain c. Dame Vandanjou*, Trib. Comm. Nantes, April 23, 1956, [1956] *Juris-Class. Pér.* No. 9640; *Soc. Guerlain c. Soc. Marie Antoinette*, Trib. Comm. Nice, April 29, 1955, *id.* with note by Plaisant and Lassier.

²³¹ *Min. Pub. c. Bugnon*, Trib. Corr. de Lyon, Oct. 3, 1956 No. 9790 [1957] *Juris-Class. Pér.* with note by Plaisant and Lassier; *Daire c. Lissac et Sté. Industrielle de Lunetterie*, Trib. Corr. de la Seine (12^e ch.), Dec. 23, 1957, [1958] *Juris-Class. Pér.* No. 10427, reversed because of invalidity of decree of 1953, Cour d'Appel de Paris (9^e ch. corr.), Oct. 29, 1958, [1958] *Juris-Class. Pér.* No. 10864.

²³² Circular of February 15, 1954, Section I, A., [1954] D. IV, 96, at 97 (1954).

²³³ Circular of February 15, 1954, Section II, A. Plaisant and Lassier, *Les ententes industrielles sous forme de sociétés ou d'associations*, *JURIS-CLASSEUR DES SOCIÉTÉS*, 178 at 9 (1955) suggest that art. 37(4) does not apply to resale price maintenance pursuant to a horizontal agreement. Even if this were correct, such agreements still would be prohibited by articles 59 *bis* and 37(3).

²³⁴ See the statements to that effect in section IIB of the Circular.

mands by producers of patented articles or products meeting special standards as to quality or dimensions.

(3) *The general prohibition against concerted restraints of trade.* It goes without saying that the most important portion of the French law for the protection of competition consists in the generalized prohibition of concerted practices in restraint of trade and the establishment of a special administrative machinery for the investigation of possible violations.²³⁵

Article 59 *bis* of Decree No. 45-1483, as inserted by the Decree of 1953, proscribes in general terms "all concerted actions, agreements, express or tacit understandings, or coalitions, in whatever form and for whatever reason, which have as their object or may have as their effect a restraint of the free exercise of competition, by hindering the lowering of the costs or prices or by favoring an artificial rise of the prices." While the scope of this prohibition is very broad, nevertheless it must not be overlooked that, as Circular No. 65 of March 31, 1954,²³⁶ emphasizes, its terms outlaw concerted restraints of the full exercise of competition only if they are susceptible of a deleterious effect on the price level. Actions of this type are, in particular, voluntary limitation of production or sales, sanctions against exceeding sales quotas fixed in advance, division of primary materials or orders among the cartel members, and division of customers according to geographical criteria.²³⁷

Moreover, the law provides for exemptions. The latter are based either on special legal authorizations or upon the ground that the measures in question have the effect of improving and extending the outlets for the production or of assuring the development of economic progress through rationalization and specialization.²³⁸

In order to facilitate the ascertainment and proper appraisal of the rather complex economic factors which determine the applicability of the law, a special advisory administrative tribunal, called Commission Technique des Ententes, is established. It is in charge of the formal investigations which are initiated either upon the request of the Minister of Economic Affairs or upon the Commission's own motion.²³⁹ It holds hearings which, however, are not open to the pub-

²³⁵ Decree No. 53-704 of August 9, 1953, art. 1.

²³⁶ *Supra* note 207.

²³⁷ Circular No. 65, at p. 10.

²³⁸ Decree No. 45-1483, art. 59 *ter.* as inserted by Decree No. 53-704.

²³⁹ Decree No. 54-97 of January 27, 1954, regulating the administration of the application of Decree No. 53-704, [1954] D. IV, 86, as amended by Decree No. 59-1004 of Aug. 17, 1959, [1959] D. IV 574; see *supra* notes 206, 216, 217, and Durand, *op. cit. supra* note 206.

lic.²⁴⁰ Its opinions which are advisory in nature must be based on stated findings and may contain recommendations concerning the practices under examination.²⁴¹ Originally the opinions of the Commission and the decisions of the Minister were considered confidential and not published. Decree No. 59-1004 of August 17, 1959,²⁴² however, provided for the publication of comprehensive annual reports by the Commission, including, by way of appendix, the individual ministerial decisions and the opinions of the Commission. The Decree specified that this mandate included the period of operation prior to its enactment. Accordingly, the Commission has now published three reports covering the period of the years 1954-1957.²⁴³ In addition, the Minister of Economic Affairs gave a detailed summary of the experience during the first three years in reply to a parliamentary inquiry addressed to him in January 1957.²⁴⁴

According to the information imparted by these sources, the Commission, during the period from April 9, 1954 to January 31, 1958, made a final disposition in fourteen cases referred to it, of which thirteen terminated in formal opinions.²⁴⁵ In a number of these proceedings the Minister of Economic Affairs, acting upon the advice of the Commission, proposed to the parties the measures deemed necessary to re-establish a sufficient degree of competition. So far as it can be deduced from the reports, in every instance where apposite, his suggestions were accepted and carried out. As a result, all proceedings reported for the indicated period had terminated amicably.²⁴⁶

In the course of these thirteen interventions, the Commission and the Minister had the opportunity to crystallize the principles guiding the application of the law, that is principles for the determination of whether a concerted action of the defined "anticompetitive"

²⁴⁰ Decree No. 54-97 of Jan. 27, 1954, art. 12, [1954], D. IV, 86.

²⁴¹ *Id.* art. 15.

²⁴² *Supra* note 216.

²⁴³ J.O., Documents Administratifs, Nos. 1, 2, and 11 (1960). The first two reports are discussed by Plaisant and Lassier, *Les trois premières années d'une politique des ententes*, [1960] D. I, 61.

²⁴⁴ Assemblée Nationale, 1957, No. 4987, J.O., Oct. 19, 1957, at 4569.

²⁴⁵ Rapport de la Commission Technique des Ententes pour les années 1954 et 1956, J.O., Documents Administratifs No. 1 (1960); Rapport de la Commission Technique des Ententes pour l'année 1956, J.O. Documents Administratifs No. 2 (1960). Rapport de la Commission Technique des Ententes pour l'année 1957, J. O. Documents Administratifs No. 11 (1960).

²⁴⁶ See Section III in the reply of the Minister of Economics to the parliamentary inquiry of 1957, *supra* note 244, and the two reports of the Commission, *supra* note 245.

character has been engaged in, and whether such conduct is exempt from the prohibition in view of the over-all beneficial effects.²⁴⁷ In developing the criteria for the solution of the latter issue the Commission developed the approach of preparing "a veritable economic balance sheet."²⁴⁸ Practices without ultimate advantages for the national economy and the consumers are condemned,²⁴⁹ while restrictive practices which, under existing conditions, tend to result in improvement of the market structure or technological progress are condoned, at least for the near future.

As the Minister and the Commission in its annual reports underscored, the criteria established by the Commission are essentially constructive. The Commission has endeavored not to tend toward a systematic suppression of cartels, but to obtain the approbation of the interested parties for its formulae of technical progress and general interest. For that reason it has favored agreements for concentration and specialization, at least as long as no danger of monopoly results.

Under the provisions of the Decree No. 45-1483, as amended, the courts possess jurisdiction to pass on the validity or invalidity of restrictive arrangements independent of the Commission and the courts are under no duty to refer such questions to the administrative tribunal. Nevertheless the courts may seek or take cognizance of the opinion of Commission, without, however, being bound by its conclusions.^{249a}

²⁴⁷ See the comments to that effect in the reply of the Minister of Economic Affairs to the parliamentary inquiry of 1957, *supra* note 244, and the discussion by the Commission in the three reports *supra* note 245. See also the discussion of this new body of decisional law by Durand, *op. cit. supra* note 206, and Plaisant and Lassier, *op. cit. supra* note 243.

²⁴⁸ See Sec. V, B in the reply of the Minister, *supra* note 244.

²⁴⁹ The response lists four types of effects which have led to the condemnation of the respective restrictive practices: (a) alignment of a common sales price on the basis of the highest costs in the branch; (b) crystallization of industrial or commercial positions which hamper the chances of the best placed enterprises for further advance, (c) creation of a factual monopoly for the benefit of a single distributor which renders the customers closely dependent upon a single merchant and does not permit them to discuss usefully either the price or the quality of service, (d) establishment of lists of minimum prices or discriminatory pricing practices.

^{249a} See the discussion to that effect in Rapport de la Commission Technique des Ententes pour l'année 1957, J.O. Documents Administratifs No. 11, at 212 (1960).

C. THE NETHERLANDS

1. HISTORICAL ANTECEDENTS OF THE ECONOMIC COMPETITION ACT OF 1956-1958

a. *The Period Before and During the German Occupation*

(1) *The Entrepreneurs' Agreements Act of 1935.* The Netherlands entered the era of special legislation with respect to cartels only as a result of, and in defense against, the demoralization of the markets produced by the great depression of the thirties.²⁵⁰ Up to that time few domestic cartels were operative in the Netherlands and their activities were not thought to call for legislative intervention. However, the cut-throat competition in the fight for survival during the depression changed the picture and was thought to create a legitimate need for market organization by means of cartels and, in appropriate cases, their compulsory extension to outsiders.

The first measure of this kind was the Entrepreneurs' Agreements Act, passed in 1935. Influenced by the then contemporary German legislation, which on the one hand provided for the curbing of cartel abuses but on the other hand authorized compulsory extension of cartels to outsiders by administrative order,²⁵¹ the Dutch law took a twofold approach.

Article 2 empowered the Minister of Economic Affairs, upon application by the industry, to render entrepreneurs' agreements, as defined by the Act,²⁵² binding on outsiders whenever, in his judgment, such agreements were, or might be, of predominant significance to the economic conditions in that particular branch of the economy, and if the public interest required such extension. Conversely, Article 6 enabled the Minister to invalidate entrepreneurs' agreements, as defined by the Act, if such action was required in the public interest.

During the period of the applicability of the Act, between 1935

²⁵⁰ For discussions of the development and status of Dutch Cartel Legislation: WEEBERS, *CONTRÔLE OP INTERNATIONALE KARTELS* 97ff. (1957); Verloren van Themaat, *Het Kartelbeleid Sinds de Bevrijding*, 1 *SOCIAAL-ECONOMISCHE WETGEVING* 129 (1952); Verloren van Themaat, *Het Kartelbeleid in de Eerste Ambtsperiode Van Minister Zijlstra*, 5 *SOCIAAL-ECONOMISCHE WETGEVING* 1 (1957).

²⁵¹ See note 43 *supra*.

²⁵² Entrepreneurs' Agreements were cartel agreements and resolutions of enterprises engaged in the field of commerce and manufacture, excluding agriculture and fisheries, concerning business dealings.

and 1941 there were 38 applications for compulsory extension, eight of which were granted, fifteen rejected, and those remaining discontinued. There was no case of invalidation under this Act.²⁵³

(2) *The Cartel Ordinance of 1941, as amended in 1943.*

The Act of 1935 was superseded by the Cartel Ordinance of November 5, 1941, enacted under the aegis of the German Occupation Authorities.²⁵⁴ This Ordinance extended the regulation and supervision of cartels and assigned vast powers in that respect to the Secretary General in the Ministry of Commerce, Trade, and Navigation.

The pivotal concept of the ordinance was that of "trade regulations," defined, after an amendment in 1943,²⁵⁵ as "provisions for the regulation of competition between persons who conduct an enterprise in any branch of commerce or trade and of whom at least one is domiciled in the Netherlands; such provisions for the regulation of competition including also provisions for the regulation of financial obligations connected with a regulation of competition applicable to the participants."²⁵⁶

The Ordinance required reduction to writing of all regulation of trade, as thus defined, if arrived at after its entry into force, as well as communication of all existing or subsequently established trade regulations to the Secretary General.²⁵⁷ Moreover it subjected their establishment, ambit of bindingness, validity, content, and execution to vast substantive powers lodged in the Secretary General. On the one hand, he was given authority either to render existing trade regulations obligatory on outsiders, whether with or without attachment of conditions,²⁵⁸ or to issue trade regulations *de novo* with obligatory force for all members of a trade or industry.²⁵⁹ On the other hand, he was empowered to:

- 1) supplement, alter or invalidate, in whole or in part, trade regulations;

²⁵³ See *Verbond van Nederlandsche Werkgevers, Wet Economische Mededinging* 9 (1958).

²⁵⁴ *Verordnung der Generalsekretäre in den Ministerien für Handel, Gewerbe und Schifffahrt und für Landwirtschaft und Fischerei über das Kartellwesen, [1941] Verordnungsblatt für die besetzten Niederländischen Gebiete* 881.

²⁵⁵ *Id.* as amended by *Verordnung der Generalsekretäre in den Ministerien für Landwirtschaft und Fischerei und für Handel, Gewerbe und Schifffahrt, wodurch die Kartellverordnung abgeändert und ergänzt wird [hereinafter cited as Cartel Ordinance], [1943] Verordnungsblatt für die besetzten Niederländischen Gebiete* 111.

²⁵⁶ *Id.* § 1(3).

²⁵⁷ *Cartel Ordinance* § 2(1) and (3)

²⁵⁸ *Id.* § 3.

²⁵⁹ *Id.* § 4.

- 2) supplement, alter, or invalidate, in whole or in part, resolutions for the execution of trade regulations;
- 3) take measures for the execution of trade regulations;
- 4) take measures for the administration of organisations or institutions entrusted with tasks connected with the execution of trade regulations.²⁶⁰

The Ordinance provided expressly that no one was permitted to use legal or economic means for the purpose of restricting others in their freedom of action relative to matters envisaged by the invalidated trade regulation or resolution for its execution and entitled anyone with a legitimate interest in the maintenance of such freedom of action to the recovery of actual or exemplary damages.²⁶¹

Moreover an amendment of 1943²⁶² entrusted the Secretary General with special powers over persons or enterprises which, by reason of factual elements or their legal status, exert a substantial influence upon market conditions. The Secretary General was authorized to give directions to such persons or enterprises relative to the conduct to be pursued by them with respect to market conditions, if, in his opinion, they exercised their influence to the injury of the general welfare, the interests of the economy as a whole, a branch of industry, or another person or enterprise.

The Secretary General was given broad investigatory powers for the execution of his functions.²⁶³

The administration of this law during the German occupation is of little interest for present purposes, as the whole economy was placed upon a totalitarian basis, and there was little room for cartel practices as such. Nevertheless the provisions of the Cartel Ordinance are of significance because they remained the basis for the status of cartels after the liberation and after the end of the economy of scarcity which required extensive controls, especially in the area of pricing.²⁶⁴

b. From the Liberation to the Enactment of the Act of 1956-1958

Toward the end of 1948 the Dutch economy returned to normalcy and cartel policy again became an issue of importance. Although a draft of a new Law on Economic Competition was prepared by

²⁶⁰ *Id.* § 6(2).

²⁶¹ *Id.* § 7(3) and (4).

²⁶² *Id.* § 7a.

²⁶³ *Id.* § 8.

²⁶⁴ Cf. Verloren van Themaat, *Het Kartelbeleid Sinds de Bevrijding*, 1 SOCIAAL-ECONOMISCHE WETGEVING 129 (1952).

the Dutch Government as early as 1950,²⁶⁵ the course of parliamentary action on the substantive aspects of the law was not completed until June 28, 1956,²⁶⁶ and the passage of final statute providing for procedural implementation and putting the act into actual operation had to wait until July 16, 1958.²⁶⁷

Meanwhile the Cartel Ordinance of 1941-1943 remained the basis for governmental intervention against restrictive practices by cartels and enterprises with dominant market power. But whereas at the time of its enactment the main thrust of this Ordinance stemmed from its provisions for compulsory cartelization and the executive assurance of market regulations, its center of gravity now shifted to the sections aiming at the protection of the market from undue interference.

The Dutch Government resorted to this ordinance as early as 1946 when it rendered three decisions for the invalidation of clauses in cartel agreements which restricted the resale trade in automobile tires to garages, to the exclusion of other retailers.²⁶⁸ The next intervention of this type occurred in 1948 when the government invalidated a clause in the cartel agreement for the illumination and electro-technical industry, requiring wholesalers to order products from Dutch manufacturers exclusively through the medium of agents.²⁶⁹ It was, however, only from the beginning of 1950 that the government had to, and did, intensify its intervention for the supervision of and curbing of abuses by cartels.²⁷⁰

There had been a tremendous increase in the number of cartels, registered under Section 2 (3) of the Cartel Ordinance in the period between 1950 and 1956.²⁷¹ In 1950 the number of cartels

²⁶⁵ For a discussion of the 1950 draft: Verloren van Themaat, *Enkele Juridische Aspecten van de Evolutie der Kartelpolitiek*, 14 *ECONOMIE* 203 (1950); Ameringen & Brabers, *Voorontwerp Economische Mededinging*, 1951 *Naamloze Vennootschap* 187; Advies van de Sociaal-Economische Raad betreffende het Voorontwerp wet Economische Mededinging, Tweede Kamer (2. Chamber), Document No. 3295, No. 4, Session 1953/54; Verloren van Themaat, *Netherlands*, in FRIEDMANN, *ANTITRUST LAWS, A COMPARATIVE SYMPOSIUM* 258 at 265 (1956).

²⁶⁶ [1956] *Staatsblad van het Koninkrijk der Nederlanden* [hereinafter cited as Stb.] 1061.

²⁶⁷ [1958] Stb. 825.

²⁶⁸ [1946] *Nederlandse Staatscourant* No. 2 and No. 39.

²⁶⁹ [1946] *Nederlandse Staatscourant* No. 222.

²⁷⁰ For references: WEEBERS, *op. cit. supra* note 250 at 100; Verloren van Themaat, *Het Kartelbeleid Sinds de Bevrijding*, 1 *SOCIAAL-ECONOMISCHE WETGEVING* 129 (1952); Verloren van Themaat, *Netherlands*, in FRIEDMANN, *ANTITRUST LAWS, A COMPARATIVE SYMPOSIUM*; Verloren van Themaat, *Het Kartelbeleid in de Eerste Ambtsperiode van Minister Zijlstra*, 5 *SOCIAAL-ECONOMISCHE WETGEVING* 1 (1957); Verloren van Themaat, *Cartel Policy in the Netherlands*, in UNIV. OF CHICAGO GRADUATE SCHOOL OF BUSINESS, *INTERNATIONAL CONFERENCE ON CONTROL OF RESTRICTIVE BUSINESS PRACTICES* 18 (1960).

²⁷¹ For details: Verloren van Themaat, *Het Kartelbeleid in de Eerste Ambtsperiode*

with national scope in the Netherlands amounted to 455; in 1956 it reached a total of 850.²⁷² In addition in 1956 there existed 1,000 registered cartels with regional or local character. As a result of the active government policy no substantial growth in the spread of cartels was observable after 1956.

In order to cope with the increasingly burdensome task and to place the necessary intervention on a more democratic basis, the Cartel Ordinance was implemented and supplemented by other acts and regulations, and, in addition, informal procedures adapted to particular purposes were worked out. Thus the Royal Decree of July 16, 1949,²⁷³ established a permanent Commission of the Economic Council to perform advisory functions in administering the Cartel Ordinance. It was replaced with a Commission for Trade Regulations, established by a decree of the Minister of Economic Affairs of May 25, 1950,²⁷⁴ with the task of rendering advice in the invalidation or compulsory extension of trade regulations. In May 1951 the duties of communicating trade regulations to the proper public officials were made the subject of a detailed administrative order,²⁷⁵ and a new statute of the same year authorized the Minister to suspend provisions in trade regulations until the completion of the final determination.²⁷⁶ Finally, investigation and prosecution of infractions against the Cartel Ordinance became more active as a result of measures taken in 1950 and 1951.²⁷⁷

On the basis thus provided, the Minister for Economic Affairs, between the beginning of 1950 and November 1956, conducted and completed 41 formal proceedings for the purpose of determining whether "there existed an occasion for invoking the powers granted in the Cartel Ordinance," especially those given by Section 6 (partial or total invalidation of cartel agreements), Section 3 (extension of cartels to outsiders), or Section 7a (orders regulating the conduct of enterprises with dominant market power).²⁷⁸

van Minister Zijlstra, 5 SOCIAAL-ECONOMISCHE WETGEVING, 1. (1957); Verloren van Themaat, *Cartel Policy in the Netherlands*, op. cit. *supra* note 270.

²⁷² About 50 regulated production, 180 contained market quota arrangements, more than 500 included price-agreements, about 250 fixed other contract terms, more than 100 incorporated exclusive dealing arrangements and 90 established central buying or selling agencies. Verloren van Themaat, *Cartel Policy in the Netherlands*, op. cit. *supra* note 270.

²⁷³ [1949] Nederlandse Staatscourant No. 172.

²⁷⁴ [1950] Nederlandse Staatscourant No. 101.

²⁷⁵ [1951] Nederlandse Staatscourant No. 89.

²⁷⁶ *Id.* No. 107.

²⁷⁷ See Verloren van Themaat, *supra* note 264, at 133.

²⁷⁸ The decisions initiating and terminating such proceedings are published in Nederlandse Staatscourant.

In the majority of the cases involving the invalidation of provisions in cartel agreements, the parties voluntarily amended the questioned provisions and thereby obviated a need for actual intervention.^{278a} In a substantial number of proceedings, however, all or some of the regulations investigated were actually declared to be enforceable, while a few investigations were closed because it became evident that there was no cause for action or because the agreements in question were terminated.²⁷⁹ At least once the Minister for Economic Affairs has used his power under Section 7a; he ordered the Milk Homogenization Enterprises of Amsterdam, Utrecht, and surroundings, to supply lawfully established grocers in these cities with packaged milk products for resale.²⁸⁰ On the other hand, the Minister so far has never used his power to extend cartels to outsiders, and he has rejected an application to that effect.²⁸¹

In assessing the scope and effectiveness of the Dutch policy against abuses by cartels, the appraisal must not be based only on the results of these half a hundred formal proceedings. They produced a body of decisional law on the basis of which the Minister for Economic Affairs was able to deal with similar abuses by other cartels on a more informal basis without request for advice from the Commission for Trade Regulations. In fact the number of these informal settlements is many times that of the formal proceedings.²⁸² As a result the latter type of investigation is resorted to only in cases (1) which present new questions of principle, (2) which involve cartels of a complicated character where it appears desirable to offer the interested parties the opportunity of clarifying by means of hearings the concrete consequences, and (3) where no agreement with the cartel in question can be reached or where the cartel as well as the Minister for various reasons prefer a formal procedure.²⁸³

^{278a} For a recent example, see the elimination of four types of restrictive practices agreed upon by the cartel of the construction industry, after they were found objectionable in an investigation, Decision of March 2, 1960, [1960] Nederlandse Staatscourant No. 45, at 7.

²⁷⁹ Cf. the survey (status of 1956) by WIJSEN, DEVELOPMENTS IN CARTEL LEGISLATION AND CARTEL POLICY IN THE NETHERLANDS 5 (Mimeo. 1957).

²⁸⁰ Decision of Oct. 2, 1957, [1957] Nederlandse Staatscourant No. 192.

²⁸¹ Application of Association of Brakefluid Manufacturers for extension of their cartel to outsiders; rejected by Decision of March 20, 1957, [1957] Nederlandse Staatscourant No. 57.

²⁸² See the statements to that effect in the discussion of the actual practice under the Cartel Ordinance by the Ministers concerned in the "Memorandum of Reply" of April 13, 1955, Second House, Doc. No. 3295 No. 7, Session 1954-1955, at 2 (1955), and the summary by Verloren van Themaat, *Het Kartelbelcid in de Eerste Ambtsperiode van Minister Zijlstra*, 5 SOCIAAL-ECONOMISCHE WETGEVING 1 [1957].

²⁸³ Verloren van Themaat, *supra* note 282.

Formal proceedings are often broad in scope, and the decisions terminating them are detailed and carefully reasoned. In summarizing the substantive principles which can be deduced from the case law thus developed, the ministers concerned with the administration of the Cartel Ordinance have isolated the following eight categories of cartel practices which have called for official intervention in the public interest:²⁸⁴

- 1) The unconditional exclusion of enterprises or groups of enterprises from the supplying or procuring of goods or services, whereby such enterprises (for example, co-operatives or department stores) are seriously hampered in exercising a particular commercial function in the same manner as other enterprises (complete boycott of particular enterprises or particular types of enterprises) ;
- 2) The conditioning of the admission of enterprises to the supplying or procuring of goods or services upon the consent of a cartel agency, without providing that the determination of whether or not the consent should be given should be made pursuant to rules of admission that are acceptable from the viewpoint of general economic policy and susceptible of being tested objectively (arbitrary action with respect to the access to a market) ;
- 3) The coercion of enterprises or groups of enterprises, either by actual exclusion or threats of exclusion from the supplying or procuring of goods or services, for the purpose of gaining compliance with stipulations in trade regulations, where such coercion does not possess utility which—from a community point of view—balances the harm flowing from the compulsion for the person subjected thereto (coercive compliance) ;
- 4) The requirement that supply be obtained through specified channels of distribution whereby an efficient and adequate provisioning of the trade or the general public may be hampered (rigidifying methods of distribution) ;
- 5) The restriction of the extent of production to a quantity smaller than the demand which reasonably can be expected (limitations on production) ;
- 6) The regulation of production in such measure that individual producers are deprived of their chance of increasing

²⁸⁴ Memorandum of Reply, April 13, 1955, Second House, Document No. 3295, No. 7, Session 1954-1955, at 1.

their share in the total production (freezing of individual positions);

- 7) The fixing of uniform minimum prices:
when there was no reason to assume that a minimum price regulation was necessary in the particular area; or
at a level or by a method of calculation amounting to an
obstacle to economically warranted competition (price-freezing);
- 8) The making of regulations of various kinds with respect to
public bids where the same are an obstacle to economically
warranted competition or effectuate price increases.

While this catalogue was meant to be neither complete nor inexorable (as the Ministers were careful to point out),²⁸⁵ it serves as a valuable guide to the principal practices deemed to constitute abuses.

2. THE ECONOMIC COMPETITION ACT OF 1956-1958

a. *General Characteristics and Scope*

Basically the new Economic Competition Act of 1956-1958²⁸⁶ continues the pattern of the Cartel Ordinance of 1941 and utilizes the practical experience gained under the previous cartel legislation. Again the Act can be classified as so-called "abuse legislation,"²⁸⁷ and, like its predecessor, it provides for three large cat-

²⁸⁵ *Id.* at 2.

²⁸⁶ [1956] Stb. No. 401; [1958] Stb. No. 412 and No. 413. The first draft of the legislation, prepared late in 1950, was submitted to the Social-Economic Council in 1951 and formed the subject of a detailed criticism by that body (published in 1953, 2d House, Doc. No. 3295-4, Sess. 1953-1954). A new draft was perfected and submitted to the Second House of the Dutch Parliament in 1953, 2d House Doc. No. 3295-2, Sess. 1953-1954. It was accompanied by an "Explanatory Memorandum" of the Ministers concerned, discussing in detail the reasons for the new legislation and the policies governing it as well as furnishing comments on the various measures envisaged, 2d House, Doc. No. 3295-3, Sess. 1953-1954. In consequence of certain objections raised by the House the Ministers concerned with the cartel policy subsequently submitted another lengthy statement on the existing practice and the principal features of the draft, Memorandum of Reply, 2d House, Doc. No. 3295-7, Sess. 1954-1955. In 1956 the substantive provisions were enacted as law, but its entry into force postponed until further implementation relating to judicial review. [1956] Stb. No. 401. In 1958 the "Law Providing for Appeal from Determinations under the Economic Competition Act" was passed, amending the Act of 1956 accordingly. [1958] Stb. No. 412. The entry into force of the Act as revised and republished ([1958] Stb. No. 413) was left to further determination. The Law was put into force by ordinance of Nov. 11, 1958, [1958] Stb. No. 491. (The Act of 1956 as amended in 1958 will hereinafter be called Economic Competition Act.)

²⁸⁷ See the statement to that effect, *op. cit. supra* note 284, at 3.

egories of measures: (a) the compulsory extension of cartels to outsiders,²⁸⁸ (b) the invalidation, in whole or in part, of cartel agreements deemed to be in conflict with the general welfare,²⁸⁹ and (c) the regulation of the conduct of enterprises with dominant market power.²⁹⁰ Despite the continuance of the established approach, however, the new Act provides for some new methods of control and incorporates a vast number of changes in detail and technical modifications.

Most of all, the new legislation aims at the replacement of the broad and untrammelled powers of the government under the Cartel Ordinance of 1941-1943 by a regulation more consonant with the standards required by the rule of law.²⁹¹ Accordingly, the new Act circumscribes carefully the forms of, and grounds for, public intervention and possible exemptions and dispensations and subjects the administrative determination to judicial review by the Tribunal of Appeal in Industrial Matters, created in 1954.²⁹² In addition, it redefines its scope of applicability by replacing the former central term of "trade regulation" with a newly created concept, designated as "competition regulation," which in some respects is broader in scope as it covers all sectors of economic activity and not only trade and industry in the narrow sense. Conversely, in other respects it is narrower as it is restricted to *legally enforceable* agreements and resolutions for the regulation of competition.²⁹³ The statute provides, however, that its applicability may be extended, by general executive order, either *in toto* to designated agreements or resolutions which merely affect competition²⁹⁴ or, as far as apposite, to designated written arrangements regulating or affecting competition which are not legally binding in character.²⁹⁵ Furthermore, publicity is introduced as a new type of sanction, both against competition arrangements deemed to be, or to be applied, in conflict with the public interest and against uses of economic power deemed to be in conflict with the public interest.²⁹⁶ Last, although not least, the new Act introduces, for

²⁸⁸ Economic Competition Act arts. 6-9.

²⁸⁹ *Id.* art. 10-15, 19-23.

²⁹⁰ *Id.* arts. 24-27.

²⁹¹ See the comments to that effect in the Explanatory Memorandum of 1953 by the responsible Ministers of State, 2d House, Doc. No. 3295-2, at 7 (1953-54).

²⁹² Economic Competition Act art. 33.

²⁹³ *Id.* art. 1(1), defining competition regulation as "agreement or resolution, pursuant to private law, which constitutes a regulation of competition among owners of enterprises."

²⁹⁴ *Id.* art. 1(3).

²⁹⁵ *Id.* art. 1(4).

²⁹⁶ *Id.* arts. 19(1)(a) and 24(1)(a).

the first time, the possibility of invalidating competition agreements of specified types of character by means of generic regulation, though not without allowance of dispensations.²⁹⁷

As under the regime of the former Cartel Ordinance, as modified in 1950, the Minister of Economic Affairs is assisted in the administration of the Act by a special advisory board, now styled the Economic Competition Commission.²⁹⁸ It consists of a minimum of twelve regular members who may be supplemented, if deemed necessary, by a number of extraordinary members. Consultation of the Commission is compulsory in formal proceedings for the issuance of generic or specific orders for the supervision or suppression of restrictive practices as authorized by the Act,²⁹⁹ as well as for the grant of dispensation from generic prohibitions.³⁰⁰

b. Particular Regulations of the New Act

(1) *Duty of registration and reduction to writing.* Like the prior law the new Act requires communication to the Minister of Economic Affairs of all competition regulations within the meaning of Article 1(1) as well as of such agreements, resolutions, and understandings to which the application of the Act has been extended, either *in toto* or as far as apposite, by administrative regulation pursuant to Article 1(3) and 1(4).³⁰¹ The contents of the notification are determined by administrative regulation.

The duty of communication is imposed upon (a) the owners of enterprises which are subject to the regulation and have their seat in the Netherlands, (b) those persons who in addition to the owners are parties to the agreement or have participated in the resolution based on private law, (c) those who have obligated themselves in writing to execute the regulation or to perform the duty of communication.³⁰² Upon request by the Minister, which may be made at any time, such persons must also submit information as to which enterprises are then subject to a specified regulation.³⁰³

Because of the broad scope of the definition of competitive regulation, the Act authorizes the Minister of Economic Affairs, where appropriate, in conjunction with another Minister interested

²⁹⁷ *Id.* arts. 10-15.

²⁹⁸ *Id.* art. 28.

²⁹⁹ *Id.* arts. 5(2), 7(1), 20(1), 25(1), 23(3), 27(3).

³⁰⁰ *Id.* art. 13(1).

³⁰¹ *Id.* art. 2(1).

³⁰² *Ibid.*

³⁰³ *Id.* art. 3.

in the matter, to establish general exemptions or, upon application, to grant individual dispensation from the duty of communication.³⁰⁴ Such exemption *must* be established for competition regulations which do not apply to competition in the Netherlands.³⁰⁵

Non-observance of the provisions for communication is a misdemeanor.³⁰⁶ In addition, the Act authorizes the government to enact general executive decrees which deprive designated competition regulations of their enforceability if they are not reduced to writing and communicated in accordance with Article 2 within one month from the time they have come into existence.³⁰⁷ The reason for this provision is the opinion of its draftsmen that penal sanctions may not suffice to guarantee the proper and timely communication of the more important competition regulations.³⁰⁸ A similar rule existed under the Cartel Ordinance of 1941-1943.³⁰⁹

(2) *Extension to outsiders.* Like its two predecessors, the new Act provides for the compulsory extension of existing competition regulations, in whole or in part, to outsiders.³¹⁰ In contrast to the Cartel Ordinance of 1941-1943, however, such exten-

³⁰⁴ *Id.* art. 4.

³⁰⁵ *Id.* art. 4(1), last sentence. Exercising the powers granted by, and executing the mandates of, art. 4, the appropriate Ministers of State issued an order on June 3, 1960, providing for dispensation from the duties under art. 2, para. 1, for the following five classes of competition regulations:

(a) those that are not in force for more than one month except where there is a stipulation for express or implied prolongation;

(b) those concluded by a supplier and a customer whereby the prices are fixed at which the customer may resell the goods obtained from the supplier;

(c) those among retailers in milk, milk products, and special milk products, as defined in art. 2, para. 1, of the Order establishing the Trade Organization of the Retail Trade in Milk and Milk and Dairy Products, aiming at the rationalization of the local supply of these goods;

(d) those which do regulate no other matters concerning economic competition except: (1) the joint purchase of goods; (2) the obligation of a supplier to supply specified goods, whether within a designated territory or not, exclusively to one customer; (3) the obligation of a customer to procure specified goods, whether within a designated territory or not, exclusively from one supplier; (4) the obligation of an agent for certain goods or services to represent exclusively one principal, whether within a designated territory or not; (5) the obligation not to exercise a specified trade or business, whether within a designated territory or not, provided that these stipulations are part of an agreement of employment or for the transfer of an enterprise which includes such trade or business; (6) the production, distribution, or procurement of goods abroad as well as the rendition or utilization of services abroad; (7) international transportation, so far as such regulation of competition covers one or more natural or juristic persons domiciled abroad;

(e) those which do not regulate economic competition within the Netherlands. [1960] *Nederlandse Staatscourant* No. 107, at 9.

³⁰⁶ *Id.* art. 41(3).

³⁰⁷ *Id.* art. 5.

³⁰⁸ Memorandum of Explanation, 2d Chamber, Document No. 3295-2, at 15 (1953-54).

³⁰⁹ Cartel Ordinance art. 2(4).

³¹⁰ Economic Competition Act arts. 6-9.

sion is no longer authorized unless one or more of the enterprises affected thereby make an application to this end.³¹¹ It requires, in addition, (a) that in a particular branch of the economy the number or the aggregate market share of the enterprises which are subject to the regulation sought to be extended, according to the judgment of the Minister of Economics, exceed substantially the number or the aggregate market share of the other enterprises and (b) that the interest of that branch of the economy, consistent with the general welfare, demands such action.³¹² The period of the compulsory extension is limited to a maximum of three years.³¹³ The law authorizes the Ministers to provide for general exemptions or, upon application, to grant individual dispensations from the regulations thus extended to outsiders.³¹⁴ Such exemptions or dispensations may be subject to limitations or conditions.³¹⁵ The dispensations may be modified or revoked, subject, however, to judicial review.³¹⁶

In consequence of such compulsory extension of a competition regulation to outsiders, the latter are bound by its terms and stipulations, such judicially enforceable obligation existing vis-à-vis any party having a legitimate interest in its performance.³¹⁷

Under the conditions as developed in recent years, the government saw no reason to resort to the use of similar powers under the previous law and rejected applications from the industry requesting it to do so.³¹⁸ Nevertheless, attempts to obtain compulsory extension of cartels to outsiders are being made even now,³¹⁹ and, at any rate, the provisions in the new Act constitute an important reserve power.

(3) *Invalidation of restrictive agreements and resolutions.* Like the prior law, the new Act makes provision for governmental action terminating or suspending, in whole or in part, the enforceability of restrictive agreements or resolutions deemed to

³¹¹ *Id.* art. 7.

³¹² *Id.* art. 6(1).

³¹³ *Id.* art. 6(2).

³¹⁴ *Id.* art. 8(1).

³¹⁵ *Id.* art. 8(2).

³¹⁶ *Id.* arts. 8(3) and 33(1) a.

³¹⁷ *Id.* art. 9.

³¹⁸ See, *e.g.*, the rejection by the Minister of Economic Affairs in March, 1957 of the application by the Association of Brakefluid Manufacturers, Veremfa, for the compulsory extension of their "brakefluid convention" to outsiders, [1957] *Nederlandse Staatscourant* No. 57, at 5.

³¹⁹ See, *e.g.*, the notifications regarding the pending application by two trade associations of opticians for the compulsory extension of a resolution by their principal officers limiting the permissibility of discounts, [1959] *Nederlandse Staatscourant* No. 64, at 13; No. 109, at 3.

be in conflict with the public interest. While, however, the former two Cartel Ordinances authorized such decrees only in individual proceedings, the new statute, following a suggestion of the Social Economic Council made in 1951, authorizes the issuance of general executive orders for the generic invalidation of certain classes and types of restrictive clauses in agreements and resolutions,³²⁰ in addition to individual intervention with respect to particular agreements or resolutions.³²¹

Generic invalidation of stipulations, in competition regulations, of a specified nature or effect may be ordered when such measure appears to be necessary in the public interest. The invalidation lapses after five years, unless revoked prior to the expiration of such period.³²² The issuance or revocation of an order containing a generic invalidation requires previous consultation of the Economic Competition Commission.³²³ Though, generally speaking, such generic invalidation applies to all clauses in conventions and resolutions falling within its scope, whether then in existence or thereafter agreed upon, the Act envisages the grant of exemptions. Accordingly, such general order may contain an authorization, pursuant to which the Minister, upon application, may render the same inapplicable to a competition regulation subsequently agreed upon which has been submitted in draft form in conjunction with such request;³²⁴ and in case of such authorization the Minister may grant an exemption also with respect to an existing competition regulation, provided that an application to that effect was submitted before the generic invalidation went into force.³²⁵ Such exemptions may be coupled with restrictions and conditions and are subject to modification or revocation.³²⁶ When an application for an exemption from a generic invalidation has been rejected or such

³²⁰ Economic Competition Act arts. 10-15.

³²¹ *Id.* arts. 19-23.

³²² *Id.* art. 10(1) and (4).

³²³ *Id.* art. 11(1). The request for advice must be published in the *Nederlandse Staatscourant*, Economic Competition Act art. 11(2). For the first example see [1959] *Nederlandse Staatscourant* No. 52, containing notice to the effect that the Minister for Economic Affairs, in conjunction with the Minister of Justice, has consulted the Commission on the question of whether a generic invalidation should be decreed of clauses in competition regulations which govern the imposition of sanctions for the infraction of a regulation without providing for a number of specified guaranties as to the impartiality of the disciplinary tribunal and the fairness of the proceedings.

Another request for advice relating to a generic invalidation of vertical resale price maintenance agreement was made on March 3, 1960, and published March 8, 1960, [1960] *Nederlandse Staatscourant* No. 47, at 7.

³²⁴ Economic Competition Act art. 12(1).

³²⁵ *Id.* art. 12(2).

³²⁶ *Id.* art. 12(3) and (4).

exemption has been modified or revoked, the Minister may suspend the enforceability of the clauses involved until final determination of the question whenever in his judgment there exists an important ground for such action.³²⁷

In case a generic invalidation of certain specified provisions in competition regulations has been decreed in accordance with the Act, any conduct tending to ignore or circumvent such measure is prohibited and made punishable.³²⁸ Where the generic invalidation results only in partial invalidity of an agreement, the parties thereto may withdraw from the remaining portion within a month from the time that the order in question has become applicable to such agreement.³²⁹

In providing for individual invalidation, in whole or in part, of particular competition regulations by special proceedings,³³⁰ the new Act retains substantially the pattern developed under the previous law. Thus the Minister may take such action only after an advisory opinion by the Economic Competition Commission has been rendered upon hearing the affected and other interested parties.³³¹ In case of urgency the Minister may suspend the regulation in question until a final determination on the invalidation has been reached.³³² The invalidation may be conditional.³³³ Ignoring or circumventing such invalidation or suspension is prohibited and punishable.³³⁴ Partial invalidation entitles the parties to timely withdrawal from the whole.³³⁵

Invalidation of an individual competition regulation is authorized by the Act if, and to the extent that, such regulation or its application, in the judgment of the Minister of Economic Affairs and other appropriate Ministers, conflicts with the public interest.³³⁶ The Act refrains from prescribing any more precise or detailed standards for the intervention by the authorities and, in particular, avoids any catalogue of proscribed categories or types of competition regulation. Rather the matter is left purposely to the develop-

³²⁷ *Id.* art. 12(6).

³²⁸ *Id.* arts. 15(1) and 41(1). Similar rules apply with respect to conduct tending to ignore or circumvent suspension orders issued in conjunction with the denial, modification or revocation of an exemption from a generic invalidation. Economic Competition Act arts. 12(8) and 41(1).

³²⁹ *Id.* art. 14.

³³⁰ *Id.* arts. 19-23.

³³¹ *Id.* art. 20.

³³² *Id.* art. 23(1).

³³³ *Ibid.*

³³⁴ *Id.* arts. 22, 23(5), 41(1).

³³⁵ *Id.* art. 21.

³³⁶ *Id.* art. 19.

ment of decisional law through a case-by-case approach.³³⁷ As a result, the administrative policies developed and articulated under the regime of the Cartel Ordinance will remain controlling, at least for the near future.³³⁸

(4) *Suppression of abuses of economic power.* Since invalidation, whether generic or individual, is an appropriate remedy only in the case of binding arrangements, the Act provides for additional forms of governmental intervention against certain uses of "positions of economic power" not resting on binding agreements or resolutions where such uses are deemed to be in conflict with the public interest.³³⁹ Accordingly, "position of economic power" is defined broadly as "factual or legal relationship in the economy which results in a dominant influence of one or several owners of enterprises upon a market for goods or services in the Netherlands."³⁴⁰

In contrast to American law or the Coal-Steel Community Treaty, the Dutch Act neither prevents nor controls excessive concentrations of economic power as such nor authorizes steps for their dissipation.³⁴¹ It merely provides for measures to curtail abuses, by empowering the authorities to impose certain duties or rules of conduct upon the persons deemed to possess such power. The Act authorizes four types of orders which may be issued in such cases,³⁴² those which

- (a) require abstention from activities tending, by legal or factual means, to induce designated owners of enterprises to pursue specified conduct in the market concerned;
- (b) require the supply of specified goods or the rendition

³³⁷ See the comments to that effect in the Memorandum of Reply of 1955, 2d House, Doc. No. 3295-7, at 4 (1955).

³³⁸ A survey of the guiding principles was recently released, in mimeographed form, by the Dutch authorities. A German translation thereof is printed in 6 WuW 428 (1959). For an instance of a recent invalidation, based on Economic Competition Act, art. 19, of an agreement among the store owners in a shopping center whereby they obligated themselves for a period of 50 years neither to conduct nor to permit the conduct of competing businesses in such stores, see [1959] Nederlandse Staatscourant No. 65, at 5 and 6. The Minister deemed such exclusive arrangements to be in conflict with the public interest for the reason that its duration was excessive and, in view of the lack of other stores in the vicinity, apt to hamper a sound development of the distribution pattern needed by the neighborhood.

³³⁹ Economic Competition Act arts. 24-27. For the necessity and functions of this type of intervention, consult especially Memorandum of Explanation of 1953, 2d House, Doc. No. 3295, at 9 (1959).

³⁴⁰ Economic Competition Act art. 1(1).

³⁴¹ See the comments to that effect in the Memorandum of Reply, 2d House, Doc. No. 3295-7, at 7 (1955).

³⁴² Economic Competition Act art. 24(1).b(1°)-(4°).

of specified services to designated persons against cash and, in the absence of other mandates to that effect, at the cash price and the terms for delivery of goods or rendition of services that are usual in the market involved;

- (c) contain rules concerning the price for specified goods or services;
- (d) contain rules concerning the terms for the delivery of specified goods or the rendering of certain services and the payment therefor, including rules which prohibit the limiting of buyers in their right to dispose of the goods purchased, or the conditioning of the delivery of specified goods or the rendering of specified services upon the purchase or sale of other goods or the acceptance or rendering of other services or the performance of certain activities.

The maximum period during which such orders may remain in force is five years.³⁴³ Their issuance requires prior consultation of the Economic Competition Commission.³⁴⁴ Compliance can be enforced by any person who has a legitimate interest in their observance.³⁴⁵ In cases of urgency the Minister of Economics may issue temporary orders of that kind while hearings before the Commission are in progress.³⁴⁶

Intervention of this type has been resorted to on various occasions in the past, and there is good reason to believe that the pertinent articles of the Act will be frequently resorted to.³⁴⁷

D. BELGIUM

I. HISTORICAL ANTECEDENTS OF THE LAW AGAINST ABUSE OF ECONOMIC POWER OF MAY 27, 1960

a. *Statutory Development and Trends of the Case Law Apart from the Cartel Decree of 1935*

(1) *Statutory development.* Belgian law relating to restrictive business practices prior to 1935 followed a course of development which was, at first, identical with and, subsequently, at

³⁴³ *Id.* art. 24(2).

³⁴⁴ *Id.* art. 25.

³⁴⁵ *Id.* art. 26.

³⁴⁶ *Id.* art. 27.

³⁴⁷ See, for instance, the recent investigation concerning resort to the powers under art. 24 for the purpose of suppressing the boycott of a wholesale grocery store by cigar manufacturers, initiated at the instigation of competing wholesale dealers of tobacco products, [1959] *Nederlandse Staatscourant* No. 91, at 4.

least parallel to that occurring in France.³⁴⁸ Thus, as a result of the annexation and incorporation of Belgium by the French in 1795,³⁴⁹ the celebrated Decree of March 2-17, 1791, establishing freedom of trade was rendered (and still is)³⁵⁰ applicable in that country; Article 419 of the French Penal Code of 1810, defining the crime of the "distortion of the price level," discussed before, likewise extended to the Belgian provinces and remained in force even after their separation from France in 1815 and their independence from the Netherlands in 1831.

The enactment of the Penal Code of 1867 did not engender any substantial change in the situation. Article 311 of that Code subjected to punishment "persons who by fraudulent means of any kind have maneuvered the rise or fall of the price for victuals, goods or notes and securities." That prohibition was supplemented, if not in fact superseded, by an Act of July 18, 1924, "for the suppression of illicit speculation in victuals and goods or notes and securities" that expanded the ambit of unlawful manipulations of the market and differentiated two distinct classes of proscribed conduct, only one being fraudulent. The new Act penalized those

³⁴⁸ For discussions of Belgium law relative to restrictive practices in general, or certain phases thereof, see especially: Del Marmol, *Le traitement juridique des contraintes économiques*, 71 JOURNAL DES TRIBUNAUX 453 (1956); Del Marmol, *Le boycottage commercial en droit privé*, ANNALES DE LA FACULTÉ DE DROIT DE LIÈGE (1956); Del Marmol, *La liberté du commerce en droit belge*, 68 JOURNAL DES TRIBUNAUX 65 (1953); Del Marmol, *La réglementation juridique des ententes industrielles en Belgique*, 10 ANNALES DE DROIT ET DE SCIENCES POLITIQUES 3 (No. 39, 1950); Del Marmol, *Les ententes industrielles en droit comparé*, in COLLECTION D'ETUDES DE LA REVUE DE LA BANQUE, at 93 (1950); Del Marmol, *La réglementation juridique des ententes industrielles*, REVUE DE DROIT INTERNATIONAL ET DE DROIT COMPARÉ, No. spécial 125 (1950); Del Marmol, *Protection contre les abus de la puissance économique*, 13 REVUE DE LA BANQUE 65 (1949); Del Marmol, *Rapport sur le boycottage commercial en droit privé belge*, 10 TRAVAUX DE L'ASSOCIATION H. CAPITANT 101 (1959); Haesaert, *Prix imposés*, in 1932 PANDECTES PÉRIODIQUES 566; LIMPENS, PRIJSHANDHAVING BUITEN CONTRACT BIJ VERKOOP VAN MERKARTIKELN (1943); Limpens and Van Ryn, *La responsabilité du tiers complice de la violation d'un contrat*, 5 REVUE CRITIQUE DE JURISPRUDENCE BELGE 85 (1951); Machiels, *Des conventions de monopole*, 70 JOURNAL DES TRIBUNAUX [hereinafter cited as JOURN. DES TRIB.] 40 (1955); Van Bunnan, *Effets à l'égard des tiers de quelques conventions conclues par autrui*, 71 JOURNAL DES TRIBUNAUX 245 (1956); Van Hecke, *De bescherming tegen misbruiken van de economische macht*, 1948 RECHTSKUNDIG WEEKBLAD 625. For discussion by non-Belgian authors see *Ententes et Monopoles dans le Monde, Benelux II, Belgique et Luxembourg*, in LA DOCUMENTATION FRANÇAISE, NOTES ET ETUDES DOCUMENTAIRES, Nos. 1777, 1778 (1953); Benz, *Kartellentwicklung und Kartellpolitik in Belgien*, in JAHN AND JUNCKERSTORFF, INTERNATIONALES HANDBUCH DER KARTELLPOLITIK (1958); Strauss and Wolff, *Kartellrecht*, in 4 SCHLEGELBERGER, RECHTSVERGL. HANDWÖRTERBUCH, 614 at 642 (1933), WEEBERS, CONTRÔLE OP INTERNATIONALE KARTELS 52 (1957).

³⁴⁹ Decree of Oct. 1, 1795, [1789-1830] Sirey, Lois Ann. 353.

³⁵⁰ See Del Marmol, *La liberté du commerce en droit belge*, 68 JOURN. DES TRIB. 65 (1953).

who by fraudulent means of any kind have maneuvered or attempted to maneuver, or maintained or attempted to maintain, the high or low level of prices for victuals or goods or notes and securities; or who, even without fraudulent means, have voluntarily maneuvered, maintained or attempted to maintain, in the national market, an abnormally high level of prices for victuals or goods or notes and securities, whether by prohibitions or agreements aiming at the fixing of minimum or maximum sales prices or by restrictions on the production or free circulation of products.³⁵¹

Owing to the limitations in scope of the second clause (which is confined to activities aiming at *abnormally* high or low price levels) and of the need for complex economic tests implicit in such restriction, this statutory regulation has remained without great practical significance.³⁵²

Further important legislation in the field of restrictive practices was enacted in 1934 when Royal Decree No. 55 of December 1934 (for the protection of producers, merchants, and consumers against certain activities tending to adulterate the normal conditions of competition) sweepingly provided for cease and desist orders against

acts contrary to honest usages in matters of commerce and industry, whereby a merchant, manufacturer or artisan . . . generally impairs or attempts to impair the ability to compete of his competitors or any of them. . . .³⁵³

This provision actually is one of the chief statutory bases of judicial intervention against restrictive practices. However, the courts have granted relief thereunder only sparingly and in especially strong cases.

Finally in 1946 the Price Control Decree of May 14 of that year expressly prohibited tying agreements entered into or demanded "under abusive exploitation of a situation of scarcity or need."³⁵⁴ Again the courts have taken a narrow view of the

³⁵¹ 2 SERVAIS AND MECHELYNCK, *LES CODES EN VIGUEUR EN BELGIQUE* 678 (29th ed. 1957).

³⁵² Cf. Del Marmol, *op. cit. supra* note 350, text at n. 22. Similarly, a legislative decree of 1945 "for the suppression of infractions against the regulations for the supply of the country" proscribes "pricing practices in excess of the normal prices" with respect to products, materials, victuals, goods, or animals and vests the courts with full powers to determine the abnormal character of the challenged prices.

³⁵³ 2 SERVAIS AND MECHELYNCK, *op. cit. supra* note 351, at 673.

³⁵⁴ *Id.* at 686. In addition Belgium, like other European countries, has special legisla-

statutory qualification and have held that in the absence of such exceptional conditions, tying clauses are unobjectionable.³⁵⁵

(2) *The trend of the case law.* Generally speaking, the Belgian courts like (or perhaps even more than) their French counterparts have been reluctant, if not loath, to invoke either the general principles of civil law or the statutory provisions listed in order to interfere with restrictive agreements, whether of the horizontal or vertical type, and have shown increasing willingness to lend their arm for the enforcement of restrictive vertical agreements even against their disregard by third parties with knowledge thereof. Thus in the case of resale price maintenance agreements it has come to be the recognized principle that a manufacturer who sells his products with the stipulation that his customers must resell the same either at a fixed retail price or by requiring further resale price agreements, and who diligently watches over the observance of this arrangement, may recover damages on quasi-delictual grounds from a third party who markets the products at a lesser amount with knowledge of the manufacturer's price system.³⁵⁶ The manufacturer is entitled to keep the distributors in line by circulars and other means of publicity.³⁵⁷ But the courts have considered it to be an unfair trade practice subject to be enjoined where competing retailers collectively tried to coerce a manufacturer to exclude a price-cutting retailer from his dealership although the resale price maintenance scheme theretofore had not been consistently enforced.³⁵⁸ In the cases of exclusive dealing arrangements, especially regional sole distributor franchises, similar trends are discernible, and courts have protected the dealer against injury re-

tion prohibiting the coupling of the promise of a gratuity with a contract of sale or for the rendition of services, Decree No. 61 of Jan. 13, 1935, 2 SERVAIS AND MECHelynck, *op. cit. supra* note 351, at 708.

³⁵⁵ See *e.g.*, M.P.C.B. (Ct. of App. Bruxelles, 1956), 71 JOURN. DES TRIB. 718.

³⁵⁶ For an important recent case discussing the bases and scope of this doctrine see Office Belge des Ventes c. S. A. Philips (Ct. of App. Bruxelles, May 13, 1958), 74 JOURN. DES TRIB. 111 (1959), with note by Van Bunnan, but *cf.* Willems c. S.A. Ets. Jacques Neefs *et al.* (Ct. of App. Bruxelles, June 8, 1955), 71 JOURN. DES TRIB. 253 (1956), with note by Van Bunnan; for surveys of the doctrinal and decisional developments see especially LIMPENS, PRIJSHANDHAVING BUITEN CONTRAT BIJ VERKOOP VAN MERKARTIKELN (1943); Del Marmol, *La liberté du commerce en droit belge*, 68 JOURN. DES TRIB. 65, at 69 (1953); Van Bunnan, *Effets à l'égard des tiers de quelques conventions conclues par autrui*, 71 JOURN. DES TRIB. 245, at 248 (1956); Del Marmol, *Rapport sur le boycottage commercial en droit privé belge*, 10 TRAVAUX DE L'ASSOCIATION H. CAPITANT 101, at 142 (1959).

³⁵⁷ Union Spépha c. S. A. Pharmacies X. *et al.* (Ct. of App. Bruxelles, 1957), 73 JOURN. DES TRIB. 290 (1958).

³⁵⁸ Anciens Laminiers à Plomb c. Van Marcke *et al.* (Com. Trib. Ghent 1953), 68 JOURN. DES TRIB. 551 (1953).

sulting from invasions of his territory by others with knowledge of his exclusive rights.³⁵⁹ However, the courts have been hesitant about giving the same protection against a competitor to a manufacturer who required his customers to obtain from him all their needed supply of a certain commodity.³⁶⁰

Similar willingness has been shown by the Belgian courts to condone, and give judicial remedies to, cartels and similar horizontal agreements whether for the fixing of prices, the division of markets, or the regulation of production, provided that such concerted action falls short of the conduct proscribed by the penal statutes mentioned before.³⁶¹ Even group boycotts are held to be unobjectionable, at least as long as they are the sanction for price-cutting or other violations of proper market behavior.³⁶²

b. *The Cartel Decree of 1935*

In the throes of the great depression of the mid-thirties, Belgium, like her neighbor the Netherlands, followed the example of Germany and enacted legislation for the compulsory extension of cartels and similar trade associations to outsiders. Royal Decree No. 62 of January 13, 1935, "authorizing the establishment of economic regulation of production and distribution" specified the conditions under which, and set up the procedures by which, "any professional association of manufacturers or distributors vested with legal personality may seek the extension of obligations, volun-

³⁵⁹ S.a.r.l. Ets. H. Horn c. Staelens-Vervae (Ct. of App. Ghent, 1955), 71 JOURN. DES TRIB. 252 (1956); Otten c. S. A. Gelec (Ct. of App. Ghent, 1958), 73 JOURN. DES TRIB. 404 (1958); Dick c. Holvoed (Ct. of App. Ghent, 1959) 23 Rechtskundig Weekblad 636 (1959); but *contra* S. A. Technique et Commerciale "Jobo" c. S. A. Les Arts Ménagers (Comm. Trib. Liège, 1954), 70 JOURN. DES TRIB. 39 (1955), noted by Machiels *ibid.*; Ets. Reno c. S. A. Van Adelsberg & De Vries (Comm. Trib. Bruxelles, 1958), 74 JOURN. DES TRIB. 81 (1959); De Greef c. Anysz (Comm. Trib. Bruxelles, 1958), 74 JOURN. DES TRIB. 82 (1959). See the discussion by Van Bunnan, *Effets à l'égard des tiers de quelques conventions conclues par autrui*, 71 JOURN. DES TRIB. 245, 249 (1958).

³⁶⁰ S. A. Coca-Cola Export Corp. c. S. A. Grandes Brasseries Ultra (Ct. of App. Ghent, 1950), 5 REV. CRIT. DE JURISPR. BELGE 81, criticized by Limpens and Van Ryn, *La responsabilité du tiers complice de la violation d'un contrat*, *ibid.* at 85, Del Marmol, *La liberté du commerce en droit belge*, 68 JOURN. DES TRIB. 65, at 66 (1953).

³⁶¹ See the discussion by Del Marmol, *La liberté du commerce en droit belge*, 68 JOURN. DES TRIB. 65, at 67 (1953); Del Marmol, *La réglementation juridique des ententes industrielles en Belgique*, 10 ANNALES DE DROIT ET DE SCIENCES POLITIQUES 3 (1950).

³⁶² See Del Marmol, *La liberté du commerce en droit belge*, 68 JOURN. DES TRIB. 65, at 67 (1953); Del Marmol, *Le Traitement juridique des contraintes économiques*, 71 JOURN. DES TRIB. 453 (1956); Del Marmol, *Le boycottage commercial en droit privé*, ANNALES DE LA FACULTÉ DE DROIT DE LIÈGE (1956); Del Marmol, *Rapport sur le boycottage commercial en droit privé belge*, 10 TRAVAUX DE L'ASSOCIATION H. CAPITANT 101, at 113 (1959).

tarily assumed by it, concerning production, distribution, sale, export or import to all other manufacturers or distributors belonging to the same branch of industry or commerce." ³⁶³

In order to accomplish such purpose, the association must address a request to that effect to the Minister for Economic Affairs.³⁶⁴ The request must be accompanied, *inter alia*, by evidence showing that the obligation sought to be extended was assumed voluntarily by manufacturers or distributors representing the indisputable majority of interest in that branch of industry and commerce and that the extension is in the general interest.³⁶⁵ The request, if deemed proper, is thereupon published in the *Moniteur Belge* with the announcement that adverse interests should register their opposition.³⁶⁶ If there is such opposition, the parties are invited to submit their controversy to a single arbitrator or to a board of arbitrators.³⁶⁷ If arbitration fails to materialize, the controversy is brought before the Council for Economic Disputes,³⁶⁸ an administrative tribunal especially created for such purpose by the Decree of 1935.³⁶⁹ If there is no valid opposition, or if the arbitrator or arbitrators or the Council for Economic Disputes render a favorable opinion, the King may grant or reject the request;³⁷⁰ if the arbitrator or arbitrators or the Council are adverse to the request, the King must reject it.³⁷¹ The obligations thus extended to outsiders also bind new manufacturers and distributors.³⁷² If such obligations limit production, importation, or exportation, no new manufacturer may enter the market without special royal authorization upon advice by the Council for Economic Disputes, specifying, if apposite, the amount of products or materials which the applicant may manufacture, import, or export.³⁷³

This Decree which seems to be still in force despite the new legis-

³⁶³ Decree No. 62, 1935, art. 1, par. 1. 2 SERVAIS AND MECHelynck, *op. cit. supra* note 351, at 692. For an excellent discussion of the provisions of, and the practice under, this decree see Moreau, *Ententes et Monopoles dans le Monde, Benelux, II Belgique et Luxembourg*, Deuxième Partie, 20 ff. (DOCUMENTATION FRANÇAISE, NOTES ET ETUDES, No. 1778) (1953).

³⁶⁴ Decree No. 62, 1935, art. 1, para. 2.

³⁶⁵ Decree No. 62, 1935, art. 1, para. 3(c).

³⁶⁶ Decree No. 62, 1935, art. 2.

³⁶⁷ Decree No. 62, 1935, art. 4.

³⁶⁸ Decree No. 62, 1935, art. 5.

³⁶⁹ Decree No. 62, 1935, art. 6 ff. Cf. Verhaegen, *Considérations sur le Conseil du Contentieux économique*, 62 JOURN. DES TRIB. 533 (1947).

³⁷⁰ Decree No. 62, 1935, art. 19, para. 1.

³⁷¹ Decree No. 62, 1935, art. 19, para. 3.

³⁷² Decree No. 62, 1935, art. 20, para. 1.

³⁷³ Decree No. 62, 1935, art. 20, para. 2-4.

lation against abuse of economic power of 1960 has apparently been applied cautiously and judiciously.³⁷⁴ According to statistics published by the Office of the Council for Economic Disputes in 1952,³⁷⁵ the total number of applications filed with the Council in the period from 1935 to the beginning of 1952 amounted to 95. Sixty-two came from associations of manufacturers, while the remaining thirty-three stemmed from associations of distributors.³⁷⁶ The majority of them were either rejected or withdrawn,³⁷⁷ but a substantial number of applications by manufacturers' groups were successful and entailed the compulsory extension of the obligations assumed by them to outsiders in a variety of industries.³⁷⁸ While most of these regulations have expired and have not been renewed, there may still be a few industries subject to regulation under this Decree.³⁷⁹

2. THE LAW OF MAY 27, 1960, FOR PROTECTION AGAINST THE ABUSE OF ECONOMIC POWER

a. *Evolution of Legislative Proposals to Curb Monopolistic Power*

As early as 1937 the Belgian Government was concerned over abuses of monopolistic power and the lack of adequate legal bases for proceeding against the abuses. A tentative draft-bill was perfected and, in 1938, submitted to the Permanent Legislative Committee; but the political events culminating in the outbreak of World War II prevented further progress.³⁸⁰

³⁷⁴ See the conclusions to that effect by Moreau, *op. cit. supra* note 363 at 25, and the comments by Verhaegen, *op. cit. supra* note 369, at 535.

³⁷⁵ Reproduced in Moreau, *Ententes et Monopoles dans le Monde, Benelux, II Belgique et Luxembourg*, Deuxième Partie, 20 at 26 (DOCUMENTATION FRANÇAISE, NOTES ET ETUDES, No. 1778) (1953).

³⁷⁶ Between 1935 and 1941 the ratio of applications by distributors' associations and those by manufacturers' associations was 27 to 38; between 1941 and 1952 it decreased to a ratio of 6 to 24. One of the main reasons for this apparent disparity has been seen in the fact that the possible closure of the market against newcomers under art. 20 applied only to manufacturers.

³⁷⁷ So far no application by associations of distributors for extensions to outsiders has ever met with success.

³⁷⁸ A report submitted in 1952 by the staff of the Council for Economic Disputes to the Central Economic Council listed 15 manufacturing industries which had been subject to economic regulation under the Decree of 1935, *viz.* carbonic acid, bolts, bottles, wire and nails, rubber, glass panes, steel bars, special glasses, water meters, cups, copper sulphate, rolling mill rolls, compressible tubing, road equipment, pressed cork.

³⁷⁹ For a survey of the status in 1954, see 1 BAUDHUIN, *CODE ÉCONOMIQUE ET FINANCIER* 1587 (1954).

³⁸⁰ For a discussion of the various Belgian drafts of legislation for the protection against abuses of economic power see Moreau, *Ententes et Monopoles dans le Monde*:

After the liberation, in January 1947, Representative Duvieusart and some of his colleagues introduced a bill for the protection against abuses of economic power, which aimed at a broad and comprehensive regulation of that subject.³⁸¹ The proposed legislation was divided into two chapters, of which the first dealt with the protection of private interests, while the second was devoted to the supervision of economic power and the protection of the public interest against abuses. In the protection of private interests the proposal differentiated in turn between that accorded to cartel members against excessive or unwarranted disciplinary measures imposed by the organization and that made available to outsiders or other third parties with respect to unduly restrictive practices. In the part providing for official intervention in the public interest the proposed legislation established procedures for ascertaining whether certain organizations had acquired dominant market power. In case of affirmative findings the public authorities were authorized to control further economic concentration in the hands of the enterprises so designated and to suppress their restrictive practices deemed to be injurious to the public interest, if necessary by dissolution. The bill provoked violent attacks from the spokesmen for industry and was subjected to extensive criticism in professional journals.³⁸² As a result, no further parliamentary action followed.

M. Duvieusart, having become Minister for Economic Affairs in 1947, proceeded to the preparation of a government bill with the same objectives, but taking account of some of the objections leveled against his former proposal. A draft of the proposed legislation was completed in 1951 and transmitted for advice to the Central Council for the Economy.³⁸³ The latter approved the bill in 1952 making, however, significant suggestions for amendments.³⁸⁴ The government draft as submitted resembled the original Duvieusart bill of 1947 in differentiating between abuses by cartels vis-à-vis third parties and practices contrary to the public interest. But

Benelux, II Belgique et Luxembourg, Deuxième Partie, 38-56 (in DOCUMENTATION FRANÇAISE, NOTES ET ETUDES, No. 1778, 1953); Günther, *Belgische Kartellpolitik*, 5 WuW 242 (1955), Belgian Senate, Doc. No. 21 (1957-1958); Belgian Senate, Doc. No. 216 (1958-1959).

³⁸¹ For the text of the bill see Belgian Chamber of Representatives, Doc. No. 123 (1946/1947).

³⁸² See especially Del Marmol, *Protection contre les abus de la puissance économique*, 1949 REVUE DE LA BANQUE 65.

³⁸³ The text of the draft is reproduced by Moreau, *op. cit. supra* note 380, at 65.

³⁸⁴ The text of the opinion of the Central Council for Economy is reproduced by Moreau, *op. cit. supra* note 380, at 49.

it differed, on the one hand, by the restriction of government investigations to cases where serious indications of abuses exist as well as the omission of restrictions on mergers and other forms of concentration, and, on the other hand, by inclusion of provisions for abuses of preponderant economic power by public entities and against implementation of the then proposed International Trade Organization. The Central Council for the Economy, in recommending modifications, suggested, in particular, the elimination of the section dealing with abuses vis-à-vis cartel members and of the chapter on Belgian cooperation in the international repression of restrictive business practices. Following this advice the government in 1953 perfected a new text of the proposed legislation and submitted it to the Council of State. The latter raised several questions and objections, especially because of the violation of the principle of the separation of powers.

As a result, the government proceeded to a further revision of the proposed legislation and submitted it again, on June 26, 1956, to the Council of State.³⁸⁵ The draft as transmitted was based squarely upon a policy which does not deem combinations or concentrations of economic power to be evils in themselves but calls for public intervention only in cases of abuses. Accordingly, it refrained from declaring cartel agreements to be invalid or illegal and rejected the introduction of a cartel register.³⁸⁶

The first part of the proposed legislation contained definitions of the two pivotal concepts of the contemplated regulation: "economic power" and "abuse." The former was defined as "power possessed by a natural or juristic person, acting individually, or by a group of such persons, acting in concert, to exert, within the territory of the Kingdom by means of industrial, commercial, agricultural or financial activities, a preponderant influence upon the supply of the market with goods or capital or upon the price or quality of particular goods and services."³⁸⁷ "Abuse" was declared to be committed, "whenever one or more private persons possessing such economic power inflict harm upon the public interest by means of practices which adulterate or restrict the normal play of competition or which hamper either the economic freedom of producers, distributors or consumers or the development of production or trade."³⁸⁸ The general definition of abuse was followed, by way

³⁸⁵ For this phase of the development see Belgian Senate, Doc. No. 21 (1957-1958).

³⁸⁶ Belgian Senate, Doc. No. 21, at 5-7.

³⁸⁷ Draft-Bill art. 1.

³⁸⁸ Draft-Bill art. 2, para. 1.

of example, by an enumeration of twelve types of practices especially apt to have the proscribed effect.³⁸⁹

The two definitions were followed by a series of provisions regulating the procedures for the ascertainment and suppression of abuses of economic power within the meaning of the law. The proposed legislation envisaged and differentiated two types of proceedings.³⁹⁰ One, aiming at the ultimate suppression of uncovered abuses, was to be of a formal nature, conducted with full investigatory powers by the officials in charge thereof and culminating in a veritable hearing before an administrative tribunal. The other was designed to be more of preliminary and informal character, conducted without broad investigatory powers of the officials in charge thereof and terminating in a report of the findings without a special hearing stage. The administrative tribunal intervening in the hearing stage was to be the Council for Economic Disputes, created by the Cartel Decree of 1935, while the actual investigation was to be entrusted to a newly established official at the Council for Economic Disputes, the Commissioner in charge of investigations of abuse of economic power. The formal procedures were to be initiated upon complaint by persons claiming to be injured by practices constituting abuse of economic power, upon request of the Minister for Economic Affairs, or upon the Commissioner's own motion. Upon conclusion of the hearing, the Council for Economic Disputes was to render a reasoned advisory opinion as to whether an abuse was established and to propose appropriate remedies. If the Minister accepted the finding of an abuse, two courses of action were to be open to him.³⁹¹ Either he might proceed in an amicable fashion and communicate recommendations for the termination of the practices in question or he might procure a royal decree determining the existence of an abuse and imposing upon the perpetrators the measures required for eliminating the abuse. Disobedience was to entail penal sanctions.

³⁸⁹ Draft-Bill art. 2, para. 2. The twelve categories of presumptively abusive practices were: (1) practices tending to raise, maintain, or lower price levels; (2) unwarranted discrimination between purchasers; (3) coercion of third persons not to sell to or buy from certain other persons; (4) selling below cost; (5) hampering improvement or operation of technical processes or inventions; (6) quantitative limitation or qualitative alteration of the production; (7) resale price maintenance; (8) division of customers; (9) stipulation of exclusive dealing or loyalty clauses; (10) tied sales; (11) restrictions of the volume of sales or purchases for economic purposes; (12) restrictive, discriminatory, or coercive measures tending to distort the distribution of primary materials, manufactured article, or credit.

³⁹⁰ See Belgian Senate, Doc. No. 21, at 43 (1957-1958).

³⁹¹ Government Draft arts. 7 and 9.

The Council of State, in passing on the draft, suggested a number of substantive changes and a rearrangement of the articles mainly for purposes of clarification.³⁹² Perhaps the most significant modifications suggested were the elimination of the enumeration of the twelve categories of practices constituting presumptively an abuse of economic power and the insertion of special provisions for the exemption of the State, its territorial subdivisions, the public entities, and other agencies of public interest subject to the authority or control of one of the Ministers of State.

The government accepted these recommendations and deposited a revised draft, following the Council of State proposal, with the Senate in November 1957.³⁹³ The bill lapsed, however, as a result of the end of the parliamentary session.

*b. Genesis and Structure of the Law of
May 27, 1960*

On June 9, 1959, the government deposited a new bill with the Senate and, after it was passed by that body, introduced it in the same form in the Chamber of Representatives on December 16, 1959.³⁹⁴ The Chamber of Representatives likewise adopted the government bill under rejection of several amendments proposed by members of the House on May 18 and 19, and the bill became law on May 27, 1960.³⁹⁵ The new statute incorporates the substance and structure of the government bill of 1957, but it is changed in some respects for the purpose of greater efficiency and streamlining, and the former absolute exemption with respect to public or quasi-public entities has been replaced by a more qualified rule. In deriving the ultimate form of the proposal the government had before it, and to a large extent followed, the views of the Central Council for the Economy and of the Council of State.³⁹⁶

The new legislation repeats the definitions of economic power and abuse contained in the 1957 draft. Thus, the actual law, like the final form of the 1957 proposal, defines abuse by means of a general formula and omits any enumeration of specific practices. Likewise, as before, provision is made for two types of initial proceedings to be conducted by or under the supervision of a newly appointed

³⁹² Belgian Senate, Doc. No. 21, at 37 ff. (1957-1958).

³⁹³ *Id.* at 28 ff.

³⁹⁴ Belgian Senate, Doc. No. 216 (1958-1959); Belgian Chamber of Representatives, Doc. Nos. 383-1 and 383-2 (1959-1960).

³⁹⁵ Belgian Chambre des Représentants, *Annales parlementaires*, Nos. 85-87 (1959-1960); 130 *MONITEUR BELGE* 4674 (June 22, 1960).

³⁹⁶ Belgian Senate, Doc. No. 216, at 5 (1958-1959).

Commissioner for investigations of abuses of economic power at the Council for Economic Disputes. These proceedings are either informal inquiries for the purpose of determining whether or not a formal prosecution shall be instituted³⁹⁷ or formal investigations.³⁹⁸ Again, the latter are to be initiated either upon complaint by injured parties or upon request of the Minister of Economics, but the Commissioner is now given the power of refusing to proceed upon complaint by private parties if he deems it to be inadmissible or unfounded. If, as a result of the preliminary investigation, the Commissioner or the Minister for Economic affairs concludes that the proceedings shall be pursued further, the case is transferred to the Council for Economic Disputes for hearing before one of its special trial divisions. As proposed before, the opinion of that tribunal is advisory only. If the Minister for Economic Affairs accepts its findings of an abuse of economic power, he must, under the new law, proceed in an amicable fashion and make such recommendations as he deems appropriate for discontinuance of the objectionable practices.³⁹⁹ If the parties accept the recommendations, the matter is settled by an agreement. If the parties fail to follow the recommendations, even after a more formal reiteration, or if they neglect to perform the agreement, the Minister may obtain a formal royal decree issuing a cease and desist order. If the abuse is committed by a juristic person which has been proceeded against previously, the royal decree may, in addition to the measures required to terminate the new abuse, add some special sanctions designed to curb existing or the acquisition of further economic power.⁴⁰⁰

Perhaps the two most important new provisions of the act are inserted for the purpose of harmonizing the Belgian law with the mandates and the policy of the European Economic Community Treaty. Thus, a new Article 28 prescribes: "Whenever the Belgian authorities have to decide, by virtue of Article 88 of the Treaty Establishing the European Economic Community, ratified by the Law of December 2, 1957, upon the permissibility of cartels and upon the abusive exploitation of a dominant position in the Common Market, such determination must be made by the authorities defined in the present law: (1) either in conformity with Articles

³⁹⁷ Art. 5. Inquiries of this type are initiated by the Commissioner either when there are serious indications of an abuse of economic power in a particular market or upon request by the Minister.

³⁹⁸ Art. 4.

³⁹⁹ Art. 14.

⁴⁰⁰ Art. 15.

85 (1) and 86 of the Treaty and following, the procedure prescribed by the present act; (2) or in conformity with Article 85 (3) of the Treaty and following the procedure provided for in Article 14, paragraph 8 *et seq.* with the exception of the three years' limitation." Furthermore, because of the fact that the European Economic Community Treaty contains, in Article 90, special rules with respect to public and quasi-public entities, the exemption contained in the former bill is changed so as to empower the King to regulate the scope and mode of the applicability of the new statute to such entities by royal decree.⁴⁰¹

E. ITALY

I. HISTORICAL EVOLUTION OF THE ITALIAN LAW RELATIVE TO ANTICOMPETITIVE PRACTICES

a. *Developments Prior to the Fascist Cartel Legislation of 1923-1936 and the Enactment of the Civil Code of 1942*

Italian law, in its current state, contains no comprehensive special legislation for the control or suppression of anticompetitive practices that is actually enforceable. Rather the chief statutory bases for legal action in this field consist of the articles contained in Book V, Title X of the Civil Code of 1942, entitled "Of the Regulation of Competition and Consortia," as supplemented by applicable articles pertaining to the law of contracts and torts and the Penal Code.⁴⁰² This condition results from, and is explainable

⁴⁰¹ Art. 27.

⁴⁰² For recent general works dealing with the legal protection of competition in Italy, see especially ASCARELLI, *TEORIA DELLA CONCORRENZA E DEI BENI IMMATERIALI* (2d ed. 1957); Ghiron, *La concorrenza e i consorzi* (in VASSALLI *et al.*, *TRATTATO DI DIRITTO CIVILE ITALIANO*, Vol. 10) (reprinted 1954); Tonni and Ferrara, *Die Konsortien im italienischen Recht* in JAHN-JUNCKERSTORFF, *INTERNATIONALES HANDBUCH DER KARTELLPOLITIK*, 285 (1958); for older books or articles treating the subject see ASCARELLI, *CONSORZI VOLONTARI TRA IMPRENDITORI* (2d ed. 1937); Ascarelli, *Le Unioni di imprese*, 33 *RIV. DEL DIR. COMM.* 152 (1935); SALANDRA, *IL DIRITTO DELLE UNIONI DI IMPRESE* (1934); Ascarelli, *Note preliminari sulle intese industriali*, 1933 *RIVISTA ITALIANA PER LE SCIENZE GIURIDICHE* 90; De Sanctis, *Das Recht der Kartelle und anderen Unternehmenszusammenfassungen in Italien* (*KARTELL UND KONZERNRECHT DES AUSLANDES*, Ed. R. ISAY, issue 4) (1928); Strauss-Wolff, *Kartellrecht: Italien* in 4 *RECHTSVERGLEICHENDES HANDWÖRTERBUCH FÜR DAS ZIVIL-UND HANDELSRECHT* (ed. Schlegelberger) 650 (1932); Ricca-Barberis, *I sindacati industriali e la giurisprudenza*, 1 *RIV. DEL DIR. COMM.* 458 (1903). For the treatment of particular aspects, see especially Santini, *La vendita a prezzo imposto*, 6 *RIV. TRIM. DI DIR. E PROC. CIVILE* 1042 (1952); Franceschelli, *Importazioni libere in zona di esclusiva e concorrenza sleale*, 3 *RIV. DI DIR. IND.*, I, 97 (1954); La Lumia, *Ancora su importazioni libere* 4 *RIV. DI DIR. IND.*, I, 5 (1955).

by, the difficulties of adapting the Italian legal system and economic structure to the sharp change in political philosophy attending the abolition of the Fascist corporative state.

Prior to the advent of Fascism, the Italian legislator had felt little need for special interference with cartels and other restrictive arrangements, apart from the general limitations on freedom of contract contained in the Civil Code of 1865⁴⁰³ and certain sections of the Penal Code of 1888. The latter penalized interference with freedom of trade through violence or threats⁴⁰⁴ and the production of a rise or fall of the prices in public markets or exchanges through the spreading of false news or use of other fraudulent means.⁴⁰⁵ Conspiracy by five or more persons to commit such offenses was likewise punishable.⁴⁰⁶

As a result of the absence of specific norms governing the legality of cartels or other restrictive combinations and because of the unwillingness of the Italian courts to deduce rules for the protection of competition against private restraints from the legislation establishing freedom of trade,⁴⁰⁷ it became recognized that cartels and similar arrangements are legal and enforceable as long as they do not engage in practices proscribed by the Penal Code or have particularly aggravated effects. The leading precedent which established the course which was followed subsequently by the courts was the decision of the Court of Cassation of Naples of May 26, 1903, in the case of *Algranati ed altri c. Ferro, Cobianchi ed altri*.⁴⁰⁸ In that controversy some members of a cartel had brought a damage action against other members because of alleged violation of certain obligations mutually assumed by them. The de-

⁴⁰³ CIVIL CODE (1865), art. 1119: "An obligation . . . resting on an illicit cause cannot have any effect"; art. 1122: "The cause is illicit, whenever it is in contravention to the law, good custom or public order."

⁴⁰⁴ PENAL CODE (1888), art. 165: "Anybody, who by means of violence or threats, restrains or hampers, in any way whatsoever, the freedom of work or trade shall be punished. . . ." For a detailed exposition of the background and scope of this provision see particularly 4 MANZINI, TRATTATO DI DIRITTO PENALE ITALIANO 715 ff. (2d ed. 1921).

⁴⁰⁵ *Id.* art. 293: "Anybody, who through the spreading of false news or other fraudulent means, produces in the public markets or commercial exchanges a rise or fall of the prices for wages, victuals, wares, or instruments which are negotiable in the public market or admitted in the lists of stock exchanges shall be punished. . . ." This article was supplemented by the special provision of art. 326 which imposed increased punishment on "anyone who, by means of false news or other fraudulent means, produces a scarcity of, or increase in price for, food stuffs. . . ." See 6 MANZINI, TRATTATO DI DIRITTO PENALE ITALIANO 265 (2d ed. 1922).

⁴⁰⁶ PENAL CODE (1888), art. 248.

⁴⁰⁷ Italian legislation establishing the freedom of trade cumulated in the Act No. 1797 of May 29, 1864, 9 Leggi e Decreti 626 (1864).

⁴⁰⁸ Court of Cassation of Naples, May 26, 1903, [1903] *Giurisprudenza Italiana* [hereinafter cited as *Giur. Ital.*] I, 1, 845.

findants claimed that agreements such as the one in question were invalid under Italian law and that therefore they were not responsible for any breach of contract. The Court of Cassation, affirming to that extent the detailed decision of the court below,⁴⁰⁹ held to the contrary. The high tribunal rested its result on the ground that, apart from the narrow and inapplicable sections of the Penal Code, Italian law contained no positive prohibition against concerted action by producers or distributors and that it was not for the judiciary to arrogate to itself the essentially legislative function of regulating the new phenomenon of joint economic action. Moreover, the Court felt that "in the case of honest cartels, the gains and savings achieved by them" might enure to the benefit not only of the members, but also of the employees and, in the long run, the consumers.

In consequence of this determination, which was much discussed in contemporary legal periodicals,⁴¹⁰ courts and textwriters accepted the position that cartels and similar anticompetitive arrangements were not prohibited in principle and that judicial intervention was apposite only in case of outright infractions of the Penal Code or other special circumstances.⁴¹¹ As a result, courts and doctrinal efforts occupied themselves primarily not with the permissibility of cartels and similar combinations, but rather with their exact juristic nature and the reciprocal rights, obligations, and remedies of their members as well as of third parties engaging in business transactions with them.⁴¹²

The Italian government likewise not only condoned such restrictive combinations by failing to take legislative action for the control or suppression of their activities, but actually fostered their existence by creating a few compulsory cartels in certain industries by special legislation.⁴¹³

⁴⁰⁹ Court of Appeals of Naples, July 2, 1900, [1900] *Giur. Ital.* I, 2, 703.

⁴¹⁰ See the detailed survey by Ricca-Barberis, *I sindacati industriali e la giurisprudenza*, 1 *RIVISTA DI DIR. COMM.* 458 (1903).

⁴¹¹ For details see De Sanctis, *op. cit. supra* note 402, 42; Ascarelli, *Note preliminari sulle intese industriali*, 1933 *RIV. ITAL. PER LE SCIENZE GIURIDICHE*, at 103, 169; Ascarelli, *Le unioni di imprese*, 33 *RIV. DI DIR. COMM.* 152, at 155 (1935).

⁴¹² These problems have been the subject of an overwhelming mass of technical controversies among Italian legal writers. For discussions under the aegis of the old civil code, see especially SALANDRA, *IL DIRITTO DELLE UNIONI DI IMPRESE (CONSORZI E GRUPPI)* (1934); ASCARELLI, *CONSORZI VOLONTARI TRA IMPRENDITORI* (2d ed. 1937); CARNELUTTI, *Natura giuridica dei consorzi industriali*, 37 *RIV. DI DIR. COMM.* I, 1 (1939); FRANCESCHELLI, *I CONSORZI INDUSTRIALI* (1939); Betti, *Società commerciale costituita per finalità di consorzio*, 39 *RIV. DI DIR. COMM.* II, 335 (1941).

⁴¹³ For the early growth of Italian cartels, see Pitigliani, *The Development of Italian Cartels Under Fascism*, 48 *JOURN. POL. ECON.* 375 at 377 (1940).

b. *The Fascist Cartel Legislation and the Regulation of the New Civil Code of 1942*

(1) *Compulsory cartels: the Act of 1932.* The Fascist tenets of the "corporative state" and a totalitarian economy prompted an even increased predilection for cartels, coupled with an effort of converting them, to a varying extent, into instruments of the state and of governmental policy. This manifested itself in further creations of compulsory cartels⁴¹⁴ and, in 1932, in the passage of a statute "concerning the establishment and the operations of consortia among enterprises engaged in the same branch of economic activity."⁴¹⁵

The new Act provided for the formation, by royal decree, of compulsory cartels among enterprises, belonging to the same branch of the economy, for the purpose of regulating production and competition and for the coordination of compulsory cartels servicing interconnected branches of the economy.⁴¹⁶ Government action of this type was predicated upon a request to that effect either by 70 percent of all the enterprises in a particular industry controlling 70 percent of the aggregate output or, in the absence of the requisite number, by firms controlling together 85 percent of the total output. In the case of agriculture the requirements were somewhat less stringent.⁴¹⁷ In addition, the government had to find that granting such request was in the interest of the national economy and tended to achieve a more rational technological or economic organization of the production.⁴¹⁸ The Act provided in detail for close supervision of the cartel activities by the government as well as by the corporative body representing the particular sector of the economy.⁴¹⁹ It regulated, in addition, various aspects of the internal organization and legal status of such compulsory cartels.⁴²⁰ Actually, the law was never applied, as a decree envisaged by it for its implementation⁴²¹ was never enacted. Rather the government

⁴¹⁴ For a survey of the status of compulsory cartels in Italy and the governmental attitude toward their establishment, see the exposition by Mussolini of the bill of 1932 regulating the formation and organization of compulsory cartels, reprinted in [1932] *Le Leggi* 753.

⁴¹⁵ Law No. 834 (1932), [1932] *Le Leggi* 753.

⁴¹⁶ Compulsory Cartelization Act, 1932, art. 1.

⁴¹⁷ Compulsory Cartelization Act, 1932, art. 2(a).

⁴¹⁸ Compulsory Cartelization Act, 1932, art. 2(b).

⁴¹⁹ Compulsory Cartelization Act, 1932, arts. 6 and 7.

⁴²⁰ Compulsory Cartelization Act, 1932, art. 5.

⁴²¹ Compulsory Cartelization Act, 1932, art. 12.

proceeded, as before, with the establishment of compulsory cartels by individual legislation.⁴²²

Formation of compulsory organizations (consortia) by special statute or decree occurred not only in industry and commerce but also in the agricultural sector of the economy, there, however, more frequently on a local basis.⁴²³ Subsequent legislation in 1938,⁴²⁴ 1939,⁴²⁵ and 1942,⁴²⁶ however, profoundly changed the status and structure of the agricultural consortia, whether voluntary or compulsory, by supplementing them with, and incorporating them into, a completely totalitarian organization of Italian agriculture.⁴²⁷

(2) *Voluntary cartels: legislation of 1936-1937.* Voluntary cartels, likewise, became of increased governmental interest under the sweep of Fascist legislation. Already the Compulsory Cartelization Act of 1932 had required voluntary cartels regulating the economic activities of their members to transmit their charters and by-laws to the authorities and, in addition, had authorized a considerably further-reaching supervision for voluntary cartels representing seventy-five or more per cent of the national production.⁴²⁸ A decree of 1936,⁴²⁹ converted into statute law in 1937,⁴³⁰ extended the imposed publicity and provided for communication to the secretariat of the appropriate corporations of annual balance sheets and detailed reports. Whenever the dis-

⁴²² See ASCARELLI, *TEORIA DELLA CONCORRENZA E DEI BENI IMMATERIALI* 126 (2d ed. 1957); Pitigliani, *op. cit. supra* note 413, at 385.

⁴²³ See Pitigliani, *op. cit. supra* note 413 at 396. For instance, a statute of July 18, 1930, [1932] *Le Leggi* 660, established a compulsory consortium of the grape growers on the island of Pantelleria, the "Consorzio viti vinicolo de Pantelleria." The subsequent insolvency of this consortium created difficult problems regarding its amenability to the bankruptcy act, Tribunale di Trapani, 1954, [1954] *Foro Italiano* [hereinafter cited as *Foro It.*] I, 1493.

⁴²⁴ Law of June 16, 1938, No. 1008 for the unification of the provincial economic entities in the field of agriculture, [1938] *Le Leggi* 819.

⁴²⁵ Law of Feb. 2, 1939, No. 159, converting into statute the Decree of Sept. 5, 1938, No. 1593 concerning the reform of the nature and organization of the Agrarian Consortia, [1939] *Le Leggi* 247, [1938] *Le Leggi* 1300.

⁴²⁶ Law of May 18, No. 566, reorganization of the economic entities for agriculture and the Agrarian Consortia, [1942] *Le Leggi* 530.

⁴²⁷ The final organization as completed by the law of 1942 consisted of diverse National Entities designed to act as an auxiliary arm of the Ministry of Agriculture and of the Provincial Agrarian Consortia charged both with regulatory and commercial functions. The latter were re-transformed into regular agricultural cooperatives by the Legislative Decree of May 7, 1948, No. 1235, concerning the organization of the agrarian consortia and the Italian federation of agrarian consortia, *Gazzetta Ufficiale*, Oct. 16, 1948, No. 242 (supp.)

⁴²⁸ Compulsory Cartelization Act, 1932, art. 10.

⁴²⁹ Royal Decree of April 16, 1936, No. 1296, [1936] *Le Leggi* 684.

⁴³⁰ Law of April 22, 1937, No. 961, [1937] *Le Leggi* 582. The exposition of the bill given by the Minister of Corporations contained a list of the 91 cartels operating during the end of 1936.

closures indicated the appositeness of such action, the Minister for Corporations was empowered to issue directives for modification of the cartel activities. Moreover, the public authorities could delegate appropriate functions to the cartels. The law, however, applied only to cartels of national importance.

(3) *The regulation of the new Civil Code of 1942.* The Civil Code of 1942 attempts to subject the whole field of lawful competition and the limitation thereof by private transactions to a comprehensive, though fairly broad, regulation.⁴³¹ It provides in general that agreements which restrict competition must be susceptible of written proof, must be limited to a defined area or activity, and must not exceed a period of five years.⁴³² It supplements this general rule with more detailed provisions governing cartels with a common organization for the coordination of production and trade (consortia)⁴³³ differentiating, in turn, between such consortia without and with external activities.⁴³⁴ The Code lists a number of conditions as to form and content which must be complied with by the contracts establishing such consortia⁴³⁵ and contains a number of other articles concerning legal status and internal functioning of the cartels.⁴³⁶ In contrast to ordinary agreements in restraint of trade, whether vertical or horizontal, which are limited to a maximum period of five years, *organized* cartels may be established for a period not exceeding ten years.⁴³⁷

The Code also includes provisions dealing with the establishment of compulsory cartels⁴³⁸ and with the necessity for government authorization and supervision.⁴³⁹ However, these sections are currently not applicable as their entry into force was postponed⁴⁴⁰

⁴³¹ CIVIL CODE 1942, Bk. V, Title X, arts. 2595-2620.

⁴³² CIVIL CODE 1942, art. 2596.

⁴³³ For a discussion of the distinction between simple cartels (falling under the rule of art. 2596) and "cartels, between several entrepreneurs exercising identical or connected economic activities, having as their object the regulation of these activities by means of a common organization" (falling under the rules of art. 2602 *ff.*), see ASCARELLI, *TEORIA DELLA CONCORRENZA E DEI BENI IMMATERIALI* 72, 86, 89, 91 (2d ed. 1957).

⁴³⁴ CIVIL CODE 1942, arts. 2606-2611, 2612-2615.

⁴³⁵ CIVIL CODE 1942, art. 2603.

⁴³⁶ CIVIL CODE 1942, arts. 2605-2611.

⁴³⁷ CIVIL CODE 1942, art. 2604, *cf.* Ascarelli, *op. cit. supra* note 433, at 89, who deems the differentiation unjustified so far as it discriminates between simple and organized cartels.

⁴³⁸ CIVIL CODE 1942, arts. 2616, 2617.

⁴³⁹ CIVIL CODE 1942, art. 2618.

⁴⁴⁰ Decree, March 30, 1942, No. 318, for the application and implementation of the Civil Code, art. 111, [1942] *Le Leggi* 380.

until the issuance of a special decree to that effect which has not been enacted as yet. As no operative prior regulation existed on the subject, Italy at present lacks any special machinery for the control of anticompetitive practices apart from the ordinary courts of justice.⁴⁴¹

Italian law likewise made no provision to curb economic concentration by horizontal or vertical integration. In fact, the trend toward a monopolistic or oligopolistic structure in all of Italy's basic industries was greatly accentuated by the operations of the Istituto per la Ricostruzione Industriale which, since its creation in 1933,⁴⁴² has achieved financial control of the state over a substantial portion of the industry of the country.⁴⁴³ In the case of enterprises endowed with a legal monopoly the Code imposes a duty to contract with any potential customer and without discrimination;⁴⁴⁴ but this rule does not cover factual monopolists.⁴⁴⁵

2. THE PRESENT STATE OF ITALIAN LAW GOVERNING ANTICOMPETITIVE PRACTICES AND PROPOSALS FOR REFORM

a. *Current State of Italian Law Governing Anticompetitive Practices*

The collapse of the Fascist regime and the formal suppression of the agencies of the corporative state⁴⁴⁶ did not result in an immediate drastic change of the law with respect to illegality or supervision of anticompetitive practices.

To be sure, the new Constitution of 1947, in Article 41, has elevated freedom of private economic initiative to an Italian civil right.⁴⁴⁷ But the actual scope of this liberty, vis-à-vis legislative action, as well as its immediate impact on the administration of justice in private controversies involving the legality or validity of anti-

⁴⁴¹ Cf. Ascarelli, *op. cit. supra* note 433, at 127.

⁴⁴² Legislative Decree No. 5 (1933), converted into a statute by Law No. 512 (1933), [1933] Le Leggi 49, 560.

⁴⁴³ See Bernini, *International Cartels and National Legislation: Some Comparative Observations*, 4 RIVISTA DI DIRITTO INDUSTRIALE, I, 39, 76 (1955).

⁴⁴⁴ CIVIL CODE 1942, art. 2597.

⁴⁴⁵ Ascarelli, *op. cit. supra* note 433, at 43 ff.

⁴⁴⁶ Legislative Decrees of August 9, 1943, No. 721, [1943] Le Leggi 473, and of Nov. 23, 1944, No. 362.

⁴⁴⁷ Italian Constitution art. 41: "Private economic initiative is free. It cannot be employed so as to be incompatible with social utility or in a way that inflicts injury to human safety, freedom or dignity. The law determines the appropriate programs and controls to the end that public and private economic activity may be directed and coordinated toward social goals."

competitive arrangements, is controversial⁴⁴⁸ and needs clarification by decisional practice.⁴⁴⁹ Apparently this Article does not prevent the establishment of compulsory cartels where such action is deemed to be in the public interest.⁴⁵⁰ At any rate, generally speaking, the permissibility or enforceability of restrictive practices, whether concerted or not, still depends primarily on the provisions of the Penal Code of 1930 and of the Civil Code of 1942, particularly its sections governing contracts, torts, and unfair competition.

The present Penal Code of 1930, like its predecessor, contains only fairly narrow prohibitions, such as the imposition of penalties on the dissemination of false news or the employment of other stratagems for the purpose of affecting the market price of goods or securities⁴⁵¹ and on the direct interference with the freedom of industry and commerce by way of violence practiced on objects or by fraudulent means.⁴⁵² Nevertheless, it has been concluded that concerted boycotts, though short of a violation of the Penal Code, may constitute a tort.⁴⁵³

In general, however, Italian law condones restrictive agreements, whether of the horizontal or vertical type, and enforces them, at least *inter partes*. Thus, stipulations for resale price maintenance and the grant of exclusive territorial distributorships have been held legitimate and enforceable between the parties.⁴⁵⁴ The Italian

⁴⁴⁸ See the controversy between Santini, *La vendita a prezzo imposto*, 6 RIV. TRIM. DI DIR. E PROC. CIV. 1042, 1050 note 18 (1952) and Ascarelli, *Sul progetto di legge "anti-trust"*, 4 RIV. TRIM. DI DIR. E PROC. CIV. 742, 749 (1950). But see also the recent exposition by the latter author on the orientation and significance of art. 41 in *TEORIA DELLA CONCORRENZA E DEI BENI INDUSTRIALI*, 11-16 (2d ed. 1957).

⁴⁴⁹ The new Italian Constitutional Court has considered the limits which legislative action may place on the liberty guaranteed by art. 41 and *vice versa* in several cases; see decision no. 29 of Jan. 26, 1957, [1957] Giur. It. I, 432 (upholding the constitutionality of public health legislation); decision no. 50 of Apr. 13, 1957, [1957] Giur. It. I, 642 (upholding the constitutionality of export or import restrictions); decision no. 103 of July 8, 1957, [1957] Foro It. I, 1139 (upholding the constitutionality of price control legislation).

⁴⁵⁰ Recent cases which have questioned the constitutionality of legislation imposing contributions to the compulsory National Cellulose and Paper Cartel on the members of the industry and, accordingly, brought that issue before the Constitutional Court, have done so only because of the retroactive character of those measures; see Corte di Cassazione, order no. 69 of Jan. 28, 1957, [1957] Le Leggi 927; order no. 70 of Jan. 28, 1957, [1957] Le Leggi 919, [1958] Giur. It. I, 1, 635; order no. 351 of June 25, 1957, [1957] Foro It. I, 1728; Tribunale di Bergamo, order of Jan. 8, 1958, [1958] Le Leggi 479, [1958] Foro It. I, 998, [1958] Giur. It. I, 2, 427.

⁴⁵¹ PENAL CODE 1930, art. 501.

⁴⁵² PENAL CODE 1930, art. 513.

⁴⁵³ Ascarelli, *op. cit. supra* note 32, at 78, 201; Grisoli, *Le boycottage en droit italien*, 10 TRAV. DE L'ASSOC. H. CAPITANT 171 (1956).

⁴⁵⁴ With respect to the validity of vertical price fixing agreements, see Dominici c. S.p.az. Palmolive, Cass., no. 3503, Oct. 26, 1955, [1956] Giur. It. I, 1, 216. The legality

courts, however, have been reluctant to provide remedies against third parties acting in disregard of such arrangements.⁴⁵⁵ Some recent authors have questioned this attitude and argued in favor of outsider liability.⁴⁵⁶

b. *Proposals for Further Antirestrictive Practices Legislation*

Italy, like other countries, has witnessed, in recent years, several proposals for more extensive legislation for the suppression and control of anticompetitive practices. Thus, in 1950 the Italian Government submitted to Parliament the draft of an "Act Containing Provisions for the Supervision of Cartel Agreements."⁴⁵⁷ The proposal was never debated and lapsed as a result of the dissolution of Parliament in 1953. In March 1955 two members of Parliament, the Hon. Malagodi and Bozzi, introduced a new bill containing "Norms for the Protection of the Freedom of Competition and Trade."⁴⁵⁸ It was much more ambitious in scope and provided not only for the filing of restrictive agreements with a newly established administrative board, but prohibited outright restrictive practices for the purpose of achieving unjustified price increases to the injury of consumers. Again the end of the parliamentary session entailed the lapse of this bill. On March 12, 1959, Representatives Malagodi, Bozzi, Cortese, and Alpino introduced a revised bill containing "Norms for the protection of the freedom of competition and trade," which considerably enlarged the scope

of exclusive dealership arrangements is settled by decisions too numerous to cite and is implied by the cases cited *infra*, note 455.

⁴⁵⁵ Recent decisions by the Corte di Cassazione have reaffirmed its traditional position that disregard by a merchant of an exclusive dealership granted to a competitor does not entail liability for the latter, whether in tort or on the basis of unfair competition; *De Marchi c. Sentieri*, Cass. Oct. 22, 1956, [1957] *Foro It.* I, 588; *Cianci c. De Marchi*, Cass. Mar. 14, 1957, [1957] *Foro It.* I, 356; *Salengo c. Ivaldi*, Cass. July 31, 1957, [1958] *Giur. It.* I, 1, 692; *Strano c. De Marchi*, Cass. Jan. 21, 1958, [1958] *Foro It.* I, 188. In the last case cited, however, the Court has qualified these general principles and held that liability for unfair competition is incurred if the outsider procures the merchandise by illicit means. On principle the same rules should govern the liability for price-cutting by outsiders, although there are no recent holdings by the Court of Cassation on that issue.

⁴⁵⁶ See in particular Santini, *La vendita a prezzo imposto*, 6 *Riv. Trim. di Dir. e Proc. Civ.* 1042, 1063 ff. (1952); Ligi, *La disciplina della concorrenza e il contratto di agenzia con esclusiva in una interessante fattispecie*, 3 *Riv. di Dir. Civile* 106 (1957), and Ligi, Note, [1957] *Foro It.* I, 588, all with copious references.

⁴⁵⁷ The text of the bill is reproduced in 4 *Riv. Trim. di Dir. e Proc. Civ.* 752 (1950), preceded by a critical discussion by Professor Ascarelli, *Sul progetto di legge "anti-trust," id.* at 742.

⁴⁵⁸ The text of the bill is reproduced in 1 *Riv. di Dir. Civ.* 369 (1955), preceded by a critical discussion by Professor Visentini, *Un progetto di legge antitrust, id.* at 358.

of the prohibitions and regulations of the previous proposal.⁴⁵⁹

Later in 1959 the Government itself prepared a Draft Bill for the protection of the freedom of competition⁴⁶⁰ which is reputed to have good prospects of being adopted in the near future. It contains comprehensive prohibitions against restrictive understandings among entrepreneurs and abuse of dominant market power, requires communication of cartel agreements to the Minister for Industry and Commerce, and establishes a special administrative and judicial machinery for its enforcement.

The principal prohibition of the bill extends to all "understandings among entrepreneurs which, by means of contracts, accords or concerted practices, or by means of clauses in charters, general or regulatory provisions, or resolutions of consortia or associations of enterprises, are capable of hampering, falsifying or limiting in any way the competition in the domestic market." Following the example of the E.E.C. Treaty the bill specifies that the prohibition applies in particular to "understandings that

- 1) fix, directly or indirectly, purchase or sales prices or other contractual terms;
- 2) limit or control production, outlets, technical development, or investments;
- 3) divide markets or sources of supply;
- 4) apply, in commercial dealings, unequal conditions to similar or equivalent goods or services;
- 5) condition the conclusion of contracts upon the acceptance of supplementary goods or services which neither by their nature nor by commercial usage are connected with the contracts themselves."⁴⁶¹

This broad interdiction of collective restraints is followed by a prohibition against abuse of dominant market power, circumscribed as "manipulating, in the market for particular goods or services, the price, the conditions of delivery, or the flow of supply in such fashion as to subject the consumers or particular categories of enterprises to unjustified burdens or restrictions." Dominant market power is deemed to exist when the respective enterprises, either by themselves or as a result of combinations, understandings, or accords, are not subject to efficient competition in the internal mar-

⁴⁵⁹ The bill is reprinted in [1959] *Foro It.* IV, 154, preceded by comments of Ligi, and in 8 *Riv. di Dir. Ind.*, I, 193 (1959), preceded by comments signed G. G., *id.* at 189.

⁴⁶⁰ For the text of the draft bill see *Testo definitivo del disegno di legge per la tutela della libertà di concorrenza*, [1960] *Foro It.* IV, 30.

⁴⁶¹ *Id.*, art. 1.

ket.⁴⁶² The bill specifies that certain transactions as such are not considered to be understandings within the meaning of the law. It includes in that list "mergers of associations, concentration of shares, management and agency contracts even though they provide for exclusive dealing, assignments or licenses of patents, except, in the case of licenses, agreements that provide for reciprocal exclusive licensing or contain additional clauses which by themselves perform anticompetitive functions."⁴⁶³ The bill requires communication to the Minister of Industry and Commerce of all understandings, whether formalized or oral, that regulate the production or the commerce of the parties thereto.⁴⁶⁴

For the proper enforcement of the law a new administrative body, called Commission for the Protection of Competition, is established. It is composed of eighteen members, chosen from specified government departments and persons with the requisite economic or legal expertise. Upon request by the Minister of Industry and Commerce, it conducts investigations for the purpose of ascertaining whether there are (communicated or non-communicated) illegal understandings in operation or whether abuses of dominant market power are being committed. It advises the Minister of its findings and suggests measures which should be adopted.⁴⁶⁵

If the Commission finds that there is an illegal understanding or abuse of dominant market power, the Minister may issue a warning to the parties involved and demand cessation of such conduct. If the parties comply, no further governmental action will be taken and they will not be subject to the penalties imposed by the law upon participation in prohibited understandings or abuse of dominant market power. If the parties fail to comply, the Minister may institute proceedings for declaratory judgment in a newly established special division of the District Court of Rome for the purpose of establishing the illegality of the understanding or the abuse of dominant market power. In case the special division makes a finding to that effect, proceedings for penalties will be instituted.

Actions for declaratory judgment of the type described are also made available to all other interested parties provided their intention of initiating such proceedings was duly communicated to the Minister at least three months prior thereto. Compliance by the

⁴⁶² *Id.*, art. 2.

⁴⁶³ *Id.*, art. 3.

⁴⁶⁴ *Id.*, art. 4.

⁴⁶⁵ *Id.*, arts. 5 and 6.

enterprises with a warning by the Minister is no bar to the latter proceedings.

Determination of the illegality of an understanding or of the abuse of dominant market power by the special division of the District Court of Rome is also required whenever such issue arises in civil, criminal or administrative proceedings. If necessary, such other proceedings must be discontinued until such determination. It is *res judicata* vis-à-vis all interested parties.⁴⁶⁶

F. LUXEMBOURG

As might be expected in view of the relative size and industrial structure of the country, as well as its close economic and legal ties with Belgium, Luxembourg has not enacted any special legislation with respect to restrictive business practices.⁴⁶⁷ In fact, as the home of one of the largest steel producers in the world, the well-known ARBED (Acieries Réunies de Burbach-Eich-Du Delange), Luxembourg was also the seat of the powerful continental European Steel Cartel, the Entente Internationale de L'Acier, which in turn was the pivot of the notorious International Steel Cartel.⁴⁶⁸

Luxemburgian law, as a result of the political history of the Duchy, still stems to a large extent from the French legislation between 1791 (proclamation of freedom of trade) and 1815⁴⁶⁹ and belongs to the French family of legal systems. Many of Luxembourg's more recent statutes and decrees, however, are copies or adaptations of Belgian acts. Thus the Penal Code of the Duchy was borrowed from its western neighbor in 1879⁴⁷⁰ and, accordingly, contains, in Article 311, an identical prohibition against fraudulent production of price rises and falls as governs in Belgium.⁴⁷¹ Similarly, a Grand Ducal Decree of January 22, 1936,⁴⁷²

⁴⁶⁶ *Id.*, arts. 11-16.

⁴⁶⁷ About the Luxembourgian law relating to restrictive business practices, see especially METZLER, *MÉLANGES DE DROIT LUXEMBOURGEOIS*, 58 ff., 260 ff. (1949); *Ententes et Monopoles dans le Monde: Benelux II, Belgique et Luxembourg* (DOCUMENTATION FRANÇAISE, NOTES ET ETUDES DOCUMENTAIRES, No. 1778) 69 ff. (1953).

⁴⁶⁸ About the E.I.A. and the International Steel Cartel, see HEXNER, *THE INTERNATIONAL STEEL CARTEL* (1943); METZLER, *op. cit. supra* note 467 at 59; LISTER, *EUROPE'S COAL AND STEEL COMMUNITY* 181 (1960).

⁴⁶⁹ Accordingly the French Civil Code of 1804 as well as the Commercial Code of 1807 are both in force in Luxembourg.

⁴⁷⁰ HAMMES, *CODE DE LA LÉGISLATION PÉNALE EN VIGUEUR DANS LE GRAND-DUCHÉ DE LUXEMBOURG*, Vol. I (1953).

⁴⁷¹ Similarly, a Grand Ducal Decree of May 31, 1938, against illegal speculation in victuals, goods, and securities, repeated the somewhat broader formula of the Belgian law of July 18, 1924 on the same subject discussed *supra* part II, sec. D. See Huss, *Le boycottage en droit luxembourgeois*, 10 *TRAV. DE ASSOC. H. CAPITANT* 176 (1956).

⁴⁷² Grand Ducal Decree of January 15, 1936, as amended by Grand Ducal Decree of

enacted for the purpose of "protecting producers, merchants and consumers against certain activities tending to falsify the normal conditions of competition," replaced the major part of a prior law against unfair competition, the new provisions being modeled after the Belgian Ordinance on that subject of 1934.⁴⁷³

While the decree against unfair competition, following the Belgian model, contains a broad and general prohibition against the infliction of harm, or the attempt to inflict harm, to the competitive capacity of a competitor, Luxemburgian courts, like their Belgian counterparts, seem to have used this provision only haltingly for the curbing of anticompetitive practices and have condoned cartels and similar restrictive arrangements.⁴⁷⁴ Resale price maintenance agreements are held to be valid and enforceable not only *inter partes*, but also, on the theory of quasi-tort or unfair competition, against price-cutting outsiders.⁴⁷⁵ The validity of exclusive dealership arrangements likewise seems to be beyond question.⁴⁷⁶

In the field of concentrations it is worth noting that Luxembourg, in 1929, enacted particular legislation aiming at the encouragement of the formation of holding companies, that is, corporations created for the purpose of acquiring and exploiting financial participation in other enterprises, by according them exemption from corporate income taxes and other fiscal advantages.⁴⁷⁷ Moreover, an enabling act of 1937 authorized the issuance of special government regulations for the purpose of modifying the general corporation and holding companies law, so far as applicable to holding companies acquiring or having acquired stock in foreign

July 16, 1938, in HAMMES, CODE DE LA LÉGISLATION PÉNALE EN VIGUEUR DANS LE GRAND-DUCHÉ DE LUXEMBOURG, Vol. II, *sub voce*, Concurrence Déloyale.

⁴⁷³ See the discussion of the Belgian ordinance, *supra* sec. D. In contrast to the Belgian ordinance, the Luxemburgian decree contains, in the list of particularized offenses, a special prohibition against sales accompanied by free gifts or trading stamps, first outlawed by Grand Ducal Decree of May 9, 1934 [1934] Pas. Lux. 343.

⁴⁷⁴ See METZLER, *op. cit. supra* note 467, at 58. It has been suggested, however, that the Grand Ducal Decree of 1936 against unfair competition, as well as the law of May 11, 1936 guaranteeing the freedom of association, provides sufficient sanctions against boycotts, especially those having the purpose of coercing outsiders to adhere to a cartel, Huss, *op. cit. supra* note 471 at 178.

⁴⁷⁵ See METZLER, *op. cit. supra* note 467, at 60.

⁴⁷⁶ Thus, ARBED has granted exclusive global distributorship for its products to the Comptoir Métallurgique Luxembourgeois [COLUMETA].

⁴⁷⁷ Law of July 31, 1929, [1929-1932] Pas. Lux. 145. Compare de Solá Cañizares, *Les sociétés financières en droit comparé*, 7 REV. INT. DE DR. COMP. 600, 603, 604 (1955). According to Maul, *La limitation de la responsabilité dans les entreprises commerciales, Rapport sur le droit luxembourgeois*, 9 TRAV. DE L'ASSOC. H. CAPITANT 124, at 127, on Jan. 1, 1955 there existed 1165 Luxemburgian holding companies incorporated as business corporations (*sociétés anonymes* or *sociétés à responsabilité limitée*).

corporations having a value of at least one billion Luxemburgian francs, and of providing for a special tax status for such companies.⁴⁷⁸

In order to comply with the mandates of the E.E.C. Treaty, the Luxemburgian government contemplates the introduction of legislation necessary for the implementation of its provisions.

III. THE PROTECTION OF COMPETITION IN THE EUROPEAN COAL AND STEEL COMMUNITY

A. FUNDAMENTAL ASPECTS OF THE LEGAL FRAMEWORK OF THE EUROPEAN COMMON MARKET FOR COAL AND STEEL

I. ORGANIZATION OF THE EUROPEAN COAL AND STEEL COMMUNITY

a. *Historical Background*

Without going into the complex political and economic reasons which prompted the establishment of the European Coal and Steel Community by the six nations participating therein,⁴⁷⁹ suffice it to say that it was conceived as the first great step toward economic integration of continental Western Europe, taking the form of a common market in a basic sector of the economy, *i.e.*, the coal and steel industries. The initial public impetus came from a declaration of the French Government on May 9, 1950, which proposed "to place the combined coal and steel production of France and Germany under a common High Authority in an organization open to other European Countries."⁴⁸⁰ The governments of the Federal Republic of Germany (with the approval of the Allied High Commission), of Italy, and of the Benelux countries accepted these

⁴⁷⁸ Act of Dec. 27, 1937, art. 1(7), [1937] Pas. Lux. 224. In exercise of the power so delegated the government, on Dec. 17, 1938, issued two decrees, one of which governed the corporate actions necessary for the acquisition by a holding company of the stock of a foreign corporation valued at a billion francs or more, while the other regulated the tax status of holding companies of that size, [1938] Pas. Lux. 505 and 511.

⁴⁷⁹ For a discussion of the varied causes and the background of the creation of the E.C.S.C., see in particular RIEBEN, *DES ENTENTES DE MAÎTRES DE FORGES AU PLAN SCHUMAN* 314 (1954); HAUSSMANN, *DER SCHUMAN-PLAN IM EUROPÄISCHEN ZWIELICHT* 7 (1952); REUTER, *LA COMMUNAUTÉ EUROPÉENNE DU CHARBON ET DE L'ACIER* 23 (1953); RACINE, *VERS UNE EUROPE NOUVELLE PAR LE PLAN SCHUMAN* 25 (1954); DIEBOLD, *THE SCHUMAN PLAN* 8 (1959); LISTER, *op. cit. supra* note 468, at 3 (1960).

⁴⁸⁰ The text of the whole declaration is reproduced in *Rapport de la Délégation Française sur le Traité et la Convention Signés à Paris le 18 Avril 1951* (published by the French Ministry for Foreign Affairs) at 9 (1951).

principles, and beginning with June 20, 1950, a conference of delegates under the chairmanship of Mr. Monnet worked out the details of the Treaty.⁴⁸¹ The draft was completed in March 1951 and the Treaty was signed on April 18, 1951.⁴⁸² Upon ratification by the member states it went into force on July 23, 1952.⁴⁸³

b. *Structure and Organs of the European Coal and Steel Community*

The "basis" of the European Coal and Steel Community is a "common market for coal and steel"⁴⁸⁴ which is subject to comprehensive and, with qualifications, exclusive economic powers vested in four Community organs, in accordance with the detailed and complex provisions of the Treaty. The exact juridical qualification of the Community and Community organs has evoked a voluminous, but largely semantic, debate, prompted in part by the fact that the Treaty itself, in one place, uses the phrase "supranational."⁴⁸⁵

The four Community organs, under whose aegis the life of the market is placed, were originally named the High Authority, the Common Assembly, the Special Council of Ministers, and the Court of Justice.⁴⁸⁶ Upon establishment of the E.E.C. and Euratom in 1957, the Common Assembly was replaced by a single assembly for the three communities, styling itself the European Parlia-

⁴⁸¹ For an account of the progress of the work of the conference which stretched over a period of nine months see RACINE, *op. cit. supra* note 479 at 76-96; cf. also Schuman, *Origines et Elaboration du Plan "Schuman,"* 3 CAHIERS DE BRUGES 266 (1953).

⁴⁸² The treaty was drafted in French and, accordingly, has only one authoritative text. The original and a German translation are published in [1952] BGBl. II, 447. An English translation was published by the High Authority. Art. 56 of the Treaty was modified in 1960 by the procedure applicable to so-called "little amendments" which is established by art. 95, para. 3, of the Treaty. The text of the new art. 56 is published in [1960] Journal Officiel des Communautés Européennes [hereinafter cited as J'Off.] 781.

⁴⁸³ [1952] BGBl. II, 978. For a brief survey of the parliamentary debates preceding the individual ratifications, see RACINE, *op. cit. supra* note 479 at 102-116; MASON, THE EUROPEAN COAL AND STEEL COMMUNITY, EXPERIMENT IN SUPRANATIONALISM 10-33 (1955); DIEBOLD, *op. cit. supra* note 479, at 78-112.

⁴⁸⁴ E.C.S.C. Treaty arts. 1, 2 and 4.

⁴⁸⁵ See the discussion, with survey of the copious literature, by MATHIJSEN, LE DROIT DE LA COMMUNAUTÉ EUROPÉENNE DU CHARBON ET DE L'ACIER 144-156 (1958); note, in addition, De Visscher, *La Communauté Européenne du Charbon et de l'Acier et les Etats Membres*, 2 ACTES OFFICIELS DU CONGRÈS INTERNATIONAL D'ETUDES SUR LA C.E.C.A. [hereinafter cited as ACTES OFFICIELS] 7, at 31 (1957); Catalano, *Le fonti normative della Comunità Europea del Carbone e dell'Acciaio*, 2 *id.* 117, at 120; Delvaux, *La notion de supranationalité dans le traité du 18 Avril 1951, créant la C.E.C.A.*, 2 *id.* 225; Münch, *Délimitation du domaine du droit des communautés supranationales par rapport au droit étatique interne*, 2 *id.* 271, at 274.

⁴⁸⁶ E.C.S.C. Treaty art. 7.

mentary Assembly, and the Court of Justice was transformed into a common Community organ.⁴⁸⁷

Without going into the details of the respective attributes and jurisdictions of the four organs, it may be indicated, in a general way, that the High Authority is envisaged as the principal executive and regulatory agency of the European Coal and Steel Community; conversely, the Parliamentary Assembly exercises general supervisory and extremely limited embryonic legislative powers, while the Special Council of Ministers, in its role as a Community institution, apart from separate responsibilities for certain organizational and budgetary matters, is established mainly as a body charged with the clearance of actions by the High Authority involving major policy determinations and with the maintenance of harmony between national and Community policies.⁴⁸⁸ The Court, of course, is the chief instrument for preserving the legality, under the Treaty, of the conduct of the Community organs, the member states, and the enterprises subject to the Community law.⁴⁸⁹

2. CHARACTER AND EXTENT OF THE DISCIPLINE OF THE COMMON MARKET FOR COAL AND STEEL

a. *Basic Orientation of the Market*

The E.C.S.C. Treaty, in Articles 2–5, spells out the fundamental law of the Community by fixing its objectives and tasks, as well as designating the basic rules for the creation, administration, and orientation of the Common Market.⁴⁹⁰ While the ultimate goals

⁴⁸⁷ Convention Relating to Certain Institutions Common to the European Communities, of March 25, 1957 [1957] BGBl. II, 1156.

⁴⁸⁸ About the institutional aspects of the E.C.S.C. see, in particular, REUTER, *LA COMMUNAUTÉ EUROPÉENNE DU CHARBON ET DE L'ACIER* (1953); Mattern, *Rechtsgrundlagen und Praxis der Montanversammlung*, 7 NJW 218 (1954); MASON, *op. cit. supra* note 483 at 34–52; De Visscher, *op. cit. supra* note 485 at 20. In actual practice the Council of Ministers has tended to function more as a representation of the divergent national interests than as a Community apparatus, and more as a policy-making agency than as a brake on the High Authority; see the comments by Reuter, *Les interventions de la Haute Autorité*, 5 ACTES OFFICIELS 7, 69.

⁴⁸⁹ See especially VALENTINE, *THE COURT OF JUSTICE OF THE EUROPEAN COAL AND STEEL COMMUNITY* (1954). The new rules of procedure are published [1959] J'L OFF. 349, [1960] J'L OFF. 13.

⁴⁹⁰ See the repeated statements to that effect by the Court of Justice for the E.C.S.C., in *Groupement des Hauts Fourneaux et Aciéries Belges c. Haute Autorité de la C.E.C.A.*, 4 REC. DE LA JURISPRUDENCE DE LA COUR [hereinafter cited as Rec.] 223, at 242–244 (1958); *Wirtschaftsvereinigung Eisen und Stahl Industrie et al. c. Haute Autorité*, *Id.* 261, at 288, 289 (1958); *Chambre Syndicale de la Sidérurgie Française c. Haute Autorité*, *Id.* 363, at 382, 383 (1958); *Société des Anciens Etablissements Aubert et Duval c. Haute Autorité*, *Id.* 399, at 417, 418 (1958); *Société d'électro-chimie, d'électro-metallurgie et des aciéries électriques d'Ugine c. Haute Autorité*, *Id.* 435, at

and aspirations of the Community may be of a social and political character, its route is determined on the basis of a predominantly economic conception: that of a coherent and non-compartmentalized, under normal conditions spontaneously functioning, effectively competitive market.⁴⁹¹ Accordingly, Article 4 enumerates four categories of actions by member states that are recognized as incompatible with a common market for coal and steel and therefore abolished and prohibited within the Community, in the manner specified by the provisions of the Treaty, *viz.*:

- (a) import and export duties, or extractions with an equivalent effect, and quantitative restrictions on the movement of coal and steel;
- (b) measures or practices discriminating among producers, among buyers or among consumers, especially with reference to prices, delivery terms and transportation rates, as well as measures or practices which hamper the buyer in the free choice of his supplier;
- (c) state subsidies or aids, or special charges imposed by the state, in any form whatsoever;
- (d) restrictive practices tending towards the division or the exploitation of the markets.

These provisions designed to blueprint the proper market mechanism are surrounded by definitions of the Community goals (Article 3) and mandates for Community action (Article 5) which, *inter alia*, direct the Community institutions to "assure to all consumers in comparable positions within the common market equal access to the sources of production,"⁴⁹² and to "assure the establishment, the maintenance and the observance of normal conditions of competition and not to interfere directly with the production and the operation of the market except when the circumstances require action."⁴⁹³

These precepts, including the fundamental prohibitions enshrined in Article 4, are not mere programs, but directly controlling rules

454, 455 (1958); Syndicat de la Sidérurgie du Centre-Midi c. Haute Autorité, *Id.* 471, at 491, 492, 493 (1958).

⁴⁹¹ About the economic conceptions and policies enshrined in the treaty see Rapport de la Délégation Française, *supra* note 480 at 71, 91; KRAWIELICKI, DAS MONOPOLVERBOT IM SCHUMAN PLAN (1952); HAUSSMANN, *op. cit.* *supra* note 479 especially 10 and 52; Reuter, *Les interventions de la Haute Autorité*, 5 ACTES OFFICIELS 7; comments by Dupriez, *id.* at 223; Demaria, *Le système des prix et la concurrence dans le marché commun*, 6 ACTES OFFICIELS 7, at 32; Allais, *Le système des prix et la concurrence dans le marché commun de la C.E.C.A.*, 6 *id.* 143, at 153.

⁴⁹² E.C.S.C. Treaty art. 3(b).

⁴⁹³ E.C.S.C. Treaty art. 5, para. 2, cl. 3.

of conduct⁴⁹⁴ that became operative immediately upon the initiation of the respective common markets for each of the three categories of products: (a) coal, iron ore, and scrap,⁴⁹⁵ (b) steel,⁴⁹⁶ and (c) special steels.⁴⁹⁷ Consequently they must be constantly taken into consideration in the application of the other provisions of the Treaty.⁴⁹⁸

b. Built-In "Dirigistic" Safety Valves

Although the basic orientation of the market discipline is that of a "tempered liberalism,"⁴⁹⁹ the framers of the Treaty realized full well, in the light of past experiences, that the scope and structure of the market for coal and steel, as well as its susceptibility to technological or cyclical changes, rendered it unrealistic to rely on an unshackled spontaneous market mechanism as the exclusive device for the achievement of the Community aims. They felt a need for empowering the Community institutions to resort, on a supranational level, to public interventions of varying character and severity.⁵⁰⁰ Accordingly, they inserted in the Treaty a "hierarchy" of allowable "dirigistic" measures, either for the purpose of promoting the maintenance, improvement, and expansion of the means of production or for the purpose of controlling the production or consumption in periods of oversupply or shortages,⁵⁰¹ subject always to the aggregate of basic limitations deriving from Articles 2-5.⁵⁰²

c. Treaty Provisions Implementing the Basic Orientation

As the normal basis of the European Coal and Steel Community is a coherent competitive market, freed from compartmentalization

⁴⁹⁴ *Groupeement des Industries Sidérurgiques Luxembourgeoises c. Haute Autorité*, 2 Rec. 53, at 91 (1956); and authorities cited note 490 *supra*.

⁴⁹⁵ The common market for coal, iron ore, and scrap was initiated on Feb. 10, 1953, but the free movement of scrap was postponed until March 15, 1953, Letters of the High Authority to the Member States of Feb. 10, 1953 and Decision 2-53, [1953] J'L OFF. 5, 6.

⁴⁹⁶ The common market for steel was initiated on May 1, 1953, [1953] J'L OFF. 112.

⁴⁹⁷ The common market for special steels was initiated on August 1, 1954, [1954] J'L OFF. 478.

⁴⁹⁸ See the authorities cited *supra* notes 490 and 494.

⁴⁹⁹ Ophüls, *Das Wirtschaftsrecht des Schumanplans*, 4 NJW 381 (1951).

⁵⁰⁰ See the analysis in *Rapport de la Délégation Française*, *supra* note 479, at 151-166; Reuter, *Les Interventions de la Haute Autorité*, 5 ACTES OFFICIELS 7 (1957).

⁵⁰¹ Measures of the latter type are price controls or, if not sufficient, rationing or restrictions on production, see E.C.S.C. Treaty arts. 5, 57, 58, 61.

⁵⁰² The details are worked out gradually by the various decisions of the Court on that subject.

or other protectionistic interferences by the national governments, as well as from restrictive or discriminatory practices by its enterprises themselves, the Treaty has not been content with the broad formulae laid down in Articles 2-5, but has implemented them with more specific regulations relating to pricing practices,⁵⁰³ to cartels and concentrations,⁵⁰⁴ and to interferences by the member states with the competitive process,⁵⁰⁵ which will be discussed in greater detail below.⁵⁰⁶

The intellectual origin of the provisions against restrictive practices and concentrations has been the subject of conflicting theses and conjectures. It is not clear whether regulations of that type were envisaged in the working papers distributed by the French delegation to the other conferees at the beginning of negotiations or whether they were inserted into the draft only at a later stage.⁵⁰⁷ To be sure, a well-informed French author has spoken of an "anti-cartel conception" as the basis of the Schuman plan;⁵⁰⁸ but other sources have asserted that the provisions in question were due to the German influence, either upon the insistence of the Occupation Authorities, who wished to anchor the effects of their decartelization and deconcentration policies vis-à-vis the German coal and steel combines into the framework of the Treaty, or because of the economic philosophy of the Adenauer government.⁵⁰⁹ At any rate, the other powers agreed on the need for such stipulations, though in advance of their own national legislation, in order to safeguard the competitive mechanism of the market.⁵¹⁰ In fact, the structure and phraseology of Article 65 show more the imprint of contemporary Belgian and French legislative techniques than the paternity of German draftsmanship.⁵¹¹

⁵⁰³ E.C.S.C. Treaty art. 60.

⁵⁰⁴ E.C.S.C. Treaty arts. 65, 66.

⁵⁰⁵ E.C.S.C. Treaty art. 67.

⁵⁰⁶ As the E.C.S.C. Court of Justice has frequently emphasized, the implementing provisions must not be construed as if standing by themselves, but must be interpreted and applied together with the norms of arts. 2-5 as a whole, if need be under reconciliation of the somewhat divergent objectives specified in art. 3. See the authorities cited *supra* notes 490 and 494.

⁵⁰⁷ See RACINE, *op. cit. supra* note 479, at 83, 93.

⁵⁰⁸ See RACINE, *op. cit. supra* note 479, at 94.

⁵⁰⁹ See the discussion by Haussmann, *op. cit. supra* note 479, at 10, 150. Actually, it appears that only art. 66 and its formulation (concentrations) was the source of special concern to the Occupation Authorities and the subject of special difficulties and negotiations. See Entwurf eines Gesetzes gegen Wettbewerbs-Beschränkungen, Deutscher Bundestag, 1st Elective Period, Doc. No. 3462, Annex 1, at 18 (1952).

⁵¹⁰ Rapport de la Délégation Française *supra* note 480, at 91, 92 (1952).

⁵¹¹ See *infra* part A, sec. 2.

d. *Coverage of the Market Discipline*

Since the European Coal and Steel Community, in its very nature, aims at only a partial or, more exactly, segmental economic integration, the extent of the coverage of the market discipline raises important issues. (1) The types of products to which the market extends are defined in three special Annexes to the Treaty, and include iron and manganese ore, scrap, pig iron and steel ingots, semi-finished products, and finished iron or steel products, such as rails, beams, wire rods, and sheets. (2) Enterprises subject to, and entitled to the Court's protection by reason of, the market discipline are the coal and steel producers within the European territories of the member states and also, but only with reference to the provisions regulating restrictive practices and concentrations, enterprises and organizations engaging in commercial distribution excepting sales to domestic consumers or artisans.⁵¹² (3) The market discipline is not restricted to private enterprises but binds nationalized enterprises, such as the French coal mining industry, as well. The Treaty does not affect the power of the member states to regulate enterprise ownership according to their own standards.⁵¹³

B. PROTECTION OF COMPETITION AGAINST COLLECTIVE RESTRAINTS OR ADULTERATIONS BY ENTERPRISES

I. NATURE AND EXTENT OF PROTECTION

a. *Sources and Types of Anticompetitive Actions and Practices in General*

(1) *Sources of proscribed actions and practices.* Since a spontaneously functioning competitive market is deemed to be, under normal conditions, the best means for achieving the Community objectives, the Treaty endeavors to shield the competitive process against various kinds of deleterious impairment. Such interference may either stem from outside sources, *i.e.*, "measures" by the member states or the Community organs, or come from within,

⁵¹² E.C.S.C. Treaty arts. 79, 80. For details see especially Grassetti, Roblot, Daig, Lagrange, van Hecke and Weber, *La Communauté et les entreprises*, 4 ACTES OFFICIELS 7 ff. Associations of Community enterprises, as specified in arts. 78, 80, may be formed and are subjected to certain rights and duties by virtue of art. 48. They may resort to the Court of the European Communities for judicial relief within the limits available to individual enterprises, E.C.S.C. Treaty art. 33, para. 2.

⁵¹³ E.C.S.C. Treaty art. 83.

i.e., "practices" by the market enterprises themselves. The Treaty contains more or less detailed provisions directed against various impairments from both classes of sources,⁵¹⁴ but this section deals only with anticompetitive practices by enterprises in the market.

(2) *Types of anticompetitive practices of enterprises envisaged by the Treaty.* The Treaty classifies anticompetitive conduct of enterprises under four main headings: (a) collective restraints or adulterations of competition,⁵¹⁵ (b) concentrations or abuses of monopolistic power,⁵¹⁶ (c) discriminations,⁵¹⁷ and (d) pricing practices, dictated by monopolistic aspirations or unfair for other considerations.⁵¹⁸ The legal sanctions against, and the powers of the Community organs with respect to, practices falling within one of these classes may vary substantially, according to what particular category is involved.

Unfortunately, however, it is easier to state the difference in *labels* than to indicate the exact content of each of these categories which have fluid boundaries and may overlap in numerous circumstances. As a result, the interrelation between the various parts of the Treaty relating to anticompetitive practices by enterprises has been the subject of much uncertainty and discussion.⁵¹⁹ There is no escape from the conclusion that the Treaty has not followed sharply defined and consistent criteria of classification, but has approached the protection of competition in a pragmatic and rather unsystematic way,⁵²⁰ leaving it to practice and theory to weld the dispersed provisions into a coherent and workable scheme. This applies with particular force to the differentiation between the

⁵¹⁴ Impairment may also result from practices by enterprises not subject to the market discipline. In such case the Treaty by its very nature is confined to indirect and limited counter-measures, e.g., as specified in art. 63.

⁵¹⁵ E.C.S.C. Treaty arts. 4(d), 65.

⁵¹⁶ E.C.S.C. Treaty art. 66(1-6) and (7).

⁵¹⁷ E.C.S.C. Treaty arts. 4(b), 60(1) (2).

⁵¹⁸ E.C.S.C. Treaty art. 60(1) (1).

⁵¹⁹ See KRAWIELICKI, *DAS MONOPOLVERBOT IM SCHUMAN PLAN* (1952); REUTER, *LA COMMUNAUTÉ EUROPÉENNE DU CHARBON ET DE L'ACIER* 202 ff. (1953); KERN, *DAS RECHT DER UNTERNEHMENSZUSAMMENSCHLÜSSE IN DER MONTANUNION* (1955); WEBBERS, *CONTRÔLE OP INTERNATIONALE KARTELS* 135 (1957); Bayer, *Das Privatrecht der Montanunion*, 17 *ZEITSCHR. F. AUSL. & INTERNAT. PRIVATRECHT* 325 (1952); Roblot, *Les relations privées des entreprises assujetties à la Communauté Européenne du Charbon et de l'Acier*, 17 *DRIT SOCIAL* 561 (1954); Abraham, *Les entreprises comme sujets de droit dans la Communauté Charbon-Acier*, 4 *CAHIERS DE BRUGES* 255 (1954); Prieur, *La notion de concentration d'entreprises au sens de l'art. 66 du Traité instituant la C.E.C.A.*, 82 *JOURN. DU DROIT INTERNATIONAL* 806 (1955); Di Cagno, *La disciplina delle intese e delle concentrazioni nel trattato istitutivo della C.E.C.A.*, 3 *RIV. DI DIR. CIV.* 759 (1957); Roblot, *Droits et devoirs des entreprises de la Communauté-Sanctions*, 4 *ACTES OFFICIELS* 19.

⁵²⁰ To the same effect REUTER, *op. cit. supra* note 519, at 202.

formation of cartels (Article 65) and concentrations (Article 66),⁵²¹ and the delimitation between prohibited pricing practices (Article 60) and concerted restraints (Article 65).⁵²²

b. Treaty Provisions Against Restraints and Adulterations by Enterprises

(1) *Text of the pertinent Treaty provisions*

(a) Article 4 (d):

The following are recognized to be incompatible with the common market for coal and steel, and are, therefore, abolished and prohibited within the Community under the conditions specified in this Treaty:

(d) restrictive practices tending towards the division or the exploitation of the markets.

(b) Article 65(1)-(3):

1. All agreements among enterprises, all decisions of associations of enterprises, and all concerted practices, tending, directly or indirectly, to hinder, restrict or adulterate⁵²³ the normal operation of competition within the common market are prohibited, and in particular those tending:

- (a) to fix or determine prices;
- (b) to restrict or control production, technical development or investments;
- (c) to divide markets, products, customers or sources of supply.

⁵²¹ Most authors seem to agree in the conclusion that the criterion which differentiates an accord creating a cartel within the meaning of art. 65 from an agreement constituting a concentration within the meaning of art. 66 lies in the retention of independent power over the management of their affairs by the principal parties to the transaction, see KRAWIELICKI, *op. cit. supra* note 519, at 55; Bayer, *op. cit. supra* note 519, at 372; REUTER, *op. cit. supra* note 519, at 216, 217; Roblot, *Les relations privées des entreprises assujetties à la C.E.C.A.*, 17 DROIT SOCIAL 561, at 571, 575; Prieur, *op. cit. supra* note 519, at 809; but *contra* Demaria, *Le système des prix et la concurrence dans le marché commun*, 6 ACTES OFFICIELS 7, at 103, n. 24 (1957): "What seems to distinguish essentially the concentration from the cartel is the policy pursued and not the property arrangement or the mode of the accord." Professor Reuter defines concentration as "an operation which places two or more enterprises under a common control over the entirety of their affairs."

⁵²² About the overlap between the prohibitions of art. 60 and art. 65 see REUTER, *op. cit. supra* note 519, at 218. Another question, much discussed in the early stages of the common market, concerned the problems as to how far the High Authority may establish price controls to counteract the effect of existing cartels in the coal and steel market. See the references in MASON, *THE EUROPEAN COAL AND STEEL COMMUNITY* 85, n. 33 (1955).

⁵²³ The French text is "fausser," which may be rendered in English as "falsify" or "adulterate." Some translations have employed the expression "distort." In this discussion "adulterate" is used as the nearest English equivalent.

2. However, the High Authority shall authorize agreements to specialize in, or to engage in joint buying or selling of, specified products, if the High Authority finds:
 - (a) that such specialization or such joint buying or selling will contribute to a substantial improvement in the production or distribution of the products in question;
 - (b) that the agreement involved is essential to achieve these results, without being more restrictive in character than is necessary for that purpose; and
 - (c) that it is not capable of giving the interested enterprises the power to determine prices, or to control or limit the production or marketing of a substantial part of the products in question within the common market, or of withdrawing them from effective competition by other enterprises within the common market.

If the High Authority should find that certain agreements are strictly analogous in their nature and effects to the above-mentioned agreements, taking into account in particular the application of this section to distributing enterprises, it shall likewise authorize such agreements, provided that it finds that they satisfy the same conditions.

Authorizations may be granted subject to specified conditions and for a limited period. In that case the High Authority shall renew authorizations once or several times if it finds that at the time of renewal the conditions stated in paragraph (a) to (c) above are still satisfied.

The High Authority shall revoke or modify an authorization if it finds that as a result of a change in circumstances the agreement no longer satisfies the conditions specified above or that the actual consequences of the agreement or its application are contrary to the conditions required for its approval.

Decisions granting, renewing, modifying, denying or revoking an authorization shall be published together with the reasons therefor; the restrictions specified in the second paragraph of Article 47 shall not apply in such cases.

3. The High Authority may obtain, in accordance with the provisions of Article 47, any information necessary for the application of this article, either by a special request addressed to the interested parties or by a general regulation defining the nature of the agreements, decisions or practices which must be communicated to the High Authority.

(2) *Scope and interpretation.* In analyzing the significance and scope of the controlling text it might be worth noting at the outset that its general scope, apart from reflecting clearly the influence of the Havana Charter, resembles most the contemporary French statutory provisions and drafts. The Commissariat au Plan, which played such an important part in the preparation of the plan subsequently announced so dramatically by Mr. Robert Schuman, was at the same period engaged in the drafting of domestic legislation for the suppression of anticompetitive practices.⁵²⁴ That work culminated in the government bill for the control of cartels, no. 9.951, which was introduced in Parliament three days after the publication of the Schuman proposal.⁵²⁵ Other legislative proposals of similar character were introduced at the same time by representative Henri Teitgen, who later assumed an active role in the Common Assembly,⁵²⁶ and by the members of the socialist party.⁵²⁷ In comparing the tenor and phraseology of these drafts with the formulation of Article 65 the great similarity between them becomes strikingly discernible. Especially the notion of protecting competition against adulteration (*fausser*), which is employed in the E.C.S.C. Treaty, can be found not only in the Belgian and Luxemburgian legislative language, as noted before,⁵²⁸ but occurs likewise in the French discussions of that period.⁵²⁹

In analyzing the range of the prohibition it is worth noting that it consists (a) of a *general clause* which proscribes all agreements, decisions, and other concerted practices which "*tend*," directly or indirectly, to hinder, restrict, or adulterate the normal operation of competition in the common market, and (b) of a *catalogue* of three *special categories* of practices, that is, price-fixing, restriction or control of production, technological development, or investment, and division of markets, products, customers, or supplies.

The exact elements of the practices proscribed by the general clause and the significance of the addition of the catalogue of specifically named practices have been the subject of numerous

⁵²⁴ See Moreau, *Les ententes professionnelles devant la loi*, at 118 in DOCUMENTATION FRANÇAISE, ENTENTES ET MONOPOLES DANS LE MONDE (1953).

⁵²⁵ Reprinted in Moreau, *op. cit. supra* note 524, at 121.

⁵²⁶ France, Assemblée Nationale, Doc. Parl., Annexe No. 8.967, Sess. Jan. 13, 1950; discussed by Moreau, *op. cit. supra* note 524, at 115.

⁵²⁷ France, Assemblée Nationale, Doc. Parl., Annexe No. 10.223, Sess. June 8, 1950; discussed by Moreau, *op. cit. supra* note 524, at 122.

⁵²⁸ See *supra* Part II, sections D and E.

⁵²⁹ See especially the counter-project of the Commission of Economic Affairs of the National Assembly, reprinted in Moreau, *op. cit. supra* note 524, at 124.

doubts and controversies.⁵³⁰ Thus the meaning of the phrase "tend to" has been much debated, and in particular there seems to be a question of whether the specific practices listed are meant to be *per se* violations for which anticompetitive tendency needs no further proof. At any rate, there seems to be agreement that the practices enumerated are proscribed only if they relate to and affect the common market. Price-fixing of pure export cartels is not prohibited.⁵³¹ Another important controversy pertains to the applicability of Article 65 to vertical agreements. While Professor Reuter has advanced the thesis that Article 65 covers only horizontal agreements, Dr. Krawielicki, Professor Roblot, and Dr. Daig have argued for its application to vertical agreements.⁵³² The High Authority seems to tend toward the latter view. In response to an inquiry by a member of the Common Assembly relative to the grant by the collieries of France and the Saar of an exclusive sales franchise to a Belgian coal distributor, it declared that such agreements might fall under the prohibitions of Article 65.⁵³³

It is, however, most important to note that the prohibitions of Article 65(1) are not all absolute in character. Article 65(2) empowers the High Authority to authorize specialization agreements with respect to specified products and arrangements establishing joint purchase or sales agencies and analogous agreements provided that such arrangements have particular beneficial effects and do not result in excessive control over the market. Cartels or other restrictive agreements which have been entered into after the initiation date of the common market for the particular type of product⁵³⁴ (new cartels) are not effective until authorization has been obtained. Whether such authorization has retro-

⁵³⁰ See especially KRAWIELICKI, *DAS MONOPOLVERBOT IM SCHUMAN PLAN*, 12 (1952); REUTER, *LA COMMUNAUTÉ EUROPÉENNE DU CHARBON ET DE L'ACIER*, 209 (1953); Roblot, *Les relations privées des entreprises assujetties à la Communauté Européenne du Charbon et de l'Acier*, 17 *DROIT SOCIAL*, 561, at 570; Roblot, *Droits et Devoirs des Entreprises*, in 4 *ACTES OFFICIELS* 28 (1958); Daig, *Discussion*, *id.* 332, at 334.

⁵³¹ KRAWIELICKI, *op. cit. supra* note 530, at 22; REUTER, *op. cit. supra* note 530, at 211, 237; Roblot, *Les relations privées etc.*, *op. cit. supra* note 530, at 572. Accordingly, the High Authority refused to interfere with the so-called Bruxelles Entente, the export cartel of West European steel producers, see Rosen, *The Brussels Entente: Export Combination in the World Steel Market*, 106 *U.P.A.L.REV.* 1079 (1958); Di Cagno, *La disciplina delle intese e delle concentrazioni nel trattato istitutivo della C.E.C.A.*, 3 *RIV. DI DIR. CIV.* 758, at 764 n. 34 (1957).

⁵³² KRAWIELICKI, *op. cit. supra* note 530, at 12; REUTER, *op. cit. supra* note 530, at 210; Roblot, *Les relations privées etc.*, *op. cit. supra* note 530, at 571; Roblot, *Droits et devoirs etc.*, *op. cit. supra* note 530, at 28; Daig, *op. cit. supra* note 530, at 335.

⁵³³ Response of March 13, 1954, [1954] *J'L OFF.* 301.

⁵³⁴ See *supra* notes 495-497.

active effect is controversial.⁵³⁵ Cartels and other restrictive agreements which existed at the date of the initiation of the common market for the particular product remained unaffected by the prohibition of Article 65(1) until August 31, 1953,⁵³⁶ and even after that time and until the actual rejection of an application for approval, if such application was filed prior to the date indicated.⁵³⁷ The High Authority has used this power of authorization, as well as that of a modification thereof, in a substantial number of cases both in the coal and the steel sector.⁵³⁸

(3) *Discrimination as anticompetitive practice.* Of particular complexity and importance is the question as to the circumstances under which discriminatory actions by enterprises are deemed to be anticompetitive practices and therefore prohibited. At the outset it must be recalled that Article 65 constitutes only a segment of the intricate and balanced market discipline of the Treaty and that it must be read in context with the broad prohibitions of Article 4(b) and (c),⁵³⁹ as well as with the special regulation of pricing in Article 60⁵⁴⁰ and the provision against the abuse of a dominant position in the market in Article 66(7). Accordingly, prohibited discriminatory practices may consist not only in the imposition of unequal terms on purchasers in comparable positions (as under the American Robinson-Patman Act), but also in the unwarranted refusal to deal with particular parties, especially

⁵³⁵ See Roblot, *Les relations privées* etc., *op. cit. supra* note 530, at 573, n. 69 (with references).

⁵³⁶ Date fixed by the High Authority's decision No. 37-53, [1953] J'L OFF. 152.

⁵³⁷ Decision of the European Court of Justice 1-58, 10 WUW 70 (1960).

⁵³⁸ For details see E.C.S.C., High Authority, SEVENTH GENERAL REPORT 146 (1959); EIGHTH GENERAL REPORT 185, 202 (1960). For important recent decisions see decision No. 14-60 of June 2, 1960, rejecting the application for authorization of the Dutch Scrap Dealers' Cartel, [1960] J'L OFF. 869, and the decision No. 16-60 of June 22, 1960, rejecting the application for consolidation of the three Ruhr Coal Sales Cartels, [1960] J'L OFF. 1014.

⁵³⁹ Reprinted p. 297 *supra*.

⁵⁴⁰ Art. 60(1) provides:

"Pricing practices contrary to the provisions of Articles 2, 3 and 4 are prohibited, and in particular:

- unfair competitive practices, in particular purely temporary or purely local price reductions which tend toward the acquisition of a position of monopoly within the common market;
- discriminatory practices involving within the common market the application by a seller of unequal conditions to comparable transactions, especially according to the nationality of the buyer.

After consulting the Consultative Committee and the Council, the High Authority may define the practices covered by this prohibition."

Pursuant to the power given to it by paragraph 2 of this section the High Authority, in 1953 and 1954, issued regulations defining certain "differentiations" in sales terms as discriminatory, Decision No. 30-53 modified by Decision No. 1-54, [1953] J'L OFF. 109, [1954] J'L OFF. 77.

where such action rests on criteria or motives which aim at, or result in, effects inconsistent with the spirit and objectives of the common market.

An illustrative example of a suppression of the latter type of discrimination occurred in 1956 in connection with the authorization of three sales cartels for corresponding groups of coal-mining corporations in the Ruhr district.⁵⁴¹ The applicants had stipulated that the cartel would supply only such wholesale distributors who—*inter alia*—(a) had sold at least 40,000 tons of solid fuel in their territory during the preceding year, (b) had procured at least 12,500 tons of the solid fuel sold from the cartel, and (c) had procured at least 25,000 tons of the solid fuel sold from the Ruhr coal mines. The High Authority, however, while approving the other conditions,⁵⁴² refused to authorize the third of these requirements for the reason that it would entail a discrimination both between the wholesale distributors and against the coal producers outside the Ruhr district. The Court of Justice sustained this decision.⁵⁴³ It held specifically that discriminatory practices within the meaning of Article 4 of the Treaty may at the same time constitute anticompetitive practices within the meaning of Article 65(1) of the Treaty and that therefore stipulations of such character were not capable of being authorized under Article 65(2).

2. SANCTIONS AGAINST AND ENFORCEMENT OF THE TREATY PROHIBITIONS

a. *Enforcement by Community Agencies*

(1) *Text of governing provisions.* The Treaty itself, as well as the Convention on Transitional Provisions, includes various

⁵⁴¹ High Authority decisions Nos. 5-56, 6-56, 7-56, [1956] J'L OFF. 29, 43, 56. These three separate sales cartels (named GEITLING, PRÄSIDENT and MAUSEGATT) were established as successors to a comprehensive cartel of the whole Ruhr coal mining industry known as GEORG, which was dissolved in 1956. An attempt to reestablish an analogous cartel failed because of the opposition of the High Authority, see *supra* note 538. An appeal against the decision is pending, [1960] J'L OFF. 1181.

⁵⁴² For later modifications and extensions of the status of the Ruhr coal sales cartels see High Authority decisions Nos. 10-57, 11-57 and 12-57, 6 [1957] J'L OFF. 159, 160, 161; High Authority decisions Nos. 16-57, 17-57, 18-57, [1957] J'L OFF. 319, 330, 341; High Authority decisions Nos. 24-57, 25-57, 26-57, [1957] J'L OFF. 629, 631, 633; High Authority decision No. 17-59, [1959] J'L OFF. 279; High Authority decision No. 36-59, [1959] J'L OFF. 736; High Authority decision No. 48-59, [1960] J'L OFF. 57; High Authority decision No. 5-60, [1960] J'L OFF. 153; High Authority decision No. 7-60, [1960] J'L OFF. 586; High Authority decision No. 9-60, [1960] J'L OFF. 601; High Authority decision No. 10-60, [1960] J'L OFF. 618; High Authority decision No. 11-60, [1960] J'L OFF. 751; High Authority decision No. 17-60 [1960] J'L OFF. 1028.

⁵⁴³ *Geitling et al. v. High Authority*, Docket No. 2-56, 3 Rec. 9 (1957); but cf. *Nold v. High Authority*, Docket No. 18-57, [1959] J'L OFF. 421 (1959); 10 WUW 75 (1960).

sections regulating the sanctions against violations and the enforcement of the prohibitions against anticompetitive practices by enterprises. The most important ones are Article 64(4) and (5) of the Coal-Steel Treaty and Section 12, paragraphs 1-3 of the Transitional Convention.

Article 65(4) provides:

Agreements or decisions prohibited by virtue of Section 1 of the present article shall be null and void and may not be invoked before any tribunal of the member states.

The High Authority shall have exclusive jurisdiction, subject to review by the Court, to pass on the conformity of such agreements or decisions with the provisions of this article.

Article 65(5) adds:

The High Authority may impose upon enterprises:

which have concluded a void agreement;

which have applied or attempted to apply, by way of arbitration, forfeiture, boycott or any other means, a void agreement or decision or an agreement for which approval has been refused or revoked;

which have obtained an authorization by means of information known to be false or misleading; or

which engage in practices contrary to the provisions of Section 1,

fining and daily penalties not to exceed twice the proceeds from the actual turnover of the products which were the subject of the agreement, decision or practice contrary to the provisions of this article; however, if the purpose of the agreement is to restrict production, technical development or investments, this maximum may be raised to 10 percent of the annual turnover of the enterprises in question, in the case of fines, and 20 percent of the daily turnover in the case of daily penalties.

Section 12 of the Transitional Convention specifies further:

Any information about the understandings or organizations referred to in Article 65 shall be communicated to the High Authority under the terms of Section 3 of the said article.

In those cases where the High Authority does not grant the authorization provided for in Section 2 of Article 65, it shall fix reasonable time limits at the expiration of which the prohibitions provided for in Article 65 shall come into effect.

In order to facilitate the liquidation of the organizations prohibited under Article 65, the High Authority may name receivers who shall be responsible to it and shall act under its instructions.

(2) *Intervention by Community agencies.* As the quoted text of the Treaty and the Convention on Transitional Provisions indicates, the High Authority has the exclusive responsibility for the direct enforcement of the prohibitions of Article 65. It possesses extensive investigatory powers and may impose fines and daily penalties, as well as compel the dissolution of prohibited organizations by the appointment of receivers. The decisions of the High Authority are directly enforceable in the member states, in accordance with the procedure governing the execution of local instruments.⁵⁴⁴ Its decisions are subject to review by the Community Court of Justice.⁵⁴⁵ Cases have come before the High Authority either following an application or on its own initiative.⁵⁴⁶ In a number of cases where authorization has been sought, it was granted only after lengthy negotiations involving substantial revision of the original agreement. In some instances authorization of particular provisions has been denied.⁵⁴⁷

b. *Sanctions by Virtue of the Legal Systems of the Member States*

(1) *Controlling Treaty provisions.* One of the most difficult problems in the application of the provisions against anti-competitive practices by enterprises subject to the discipline of the Coal-Steel Community Treaty is the question as to the possible legal consequences of violations according to the individual legal systems of member states.⁵⁴⁸ Article 65 itself contains only two

⁵⁴⁴ E.C.S.C. Treaty arts. 44 and 92. See the comments by Spaak, *Problems of Competition and Restrictive Trade Practices in the European Coal and Steel Community*, FEDERAL BAR ASS'N INSTITUTE ON LEGAL ASPECTS OF THE EUROPEAN COMMUNITY 118, at 129 (1960).

⁵⁴⁵ Depending upon the measures taken by the High Authority review will be available either in proceedings for annulment, under art. 33 para. 2 of the E.C.S.C. Treaty, or in proceedings for full review, under art. 36 of the Treaty. In proceedings of the latter type which are available against monetary sanctions and penalties the Court may not only reverse their imposition but also reduce their amount, cf. *Acciaierie Laminatoi Magliano Alpi v. High Authority*, Docket No. 8-56, 3 Rec. 179 (1957). In cases of a failure to intervene, injured third parties might proceed against the High Authority in a damage action based on administrative tort under E.C.S.C. Treaty art. 40.

⁵⁴⁶ See the table in E.C.S.C. High Authority, EIGHTH GENERAL REPORT 202 (1960).

⁵⁴⁷ See the action by the High Authority vis-à-vis the three Ruhr coal sales cartels, discussed *supra*.

⁵⁴⁸ For European discussions of this question see especially Bayer, *Das Privatrecht*

mandates in that respect. On the one hand, it ordains that agreements and decisions violative of Article 65(1) are absolutely void and incapable of being invoked in any tribunal of the member states. On the other hand, it provides that the High Authority and, on review, the Court of Justice have the sole jurisdiction over determinations of the conformity of agreements and decisions with the rules of Article 65.⁵⁴⁹

Accordingly, it is clear that national tribunals may not lend their arm to the enforcement of anticompetitive agreements and decisions by parties thereto and must refer the matter to the High Authority if in such controversy the enforceability is contested. More difficult, however, is the question of whether and in what way national courts may grant affirmative relief to third parties claiming to be aggrieved by anticompetitive practices by others. Since Article 65 reserves the determination of the illegal character of challenged agreements, decisions, or concerted practices⁵⁵⁰ to specified Community agencies, it has been held that national courts are barred from issuing temporary injunctions.⁵⁵¹ The issue arose in consequence of a resolution of the Coal Distribution Cartel for the Upper Rhine Region, adopted in 1953, according to which coal consumers of annual amounts of 30,000 tons and more were to procure their supply directly from the cartel instead of buying from wholesale distributors. The new arrangement caused disadvantages not only for the excluded wholesale dealers, but also for the consumers as it deprived the latter of certain quantity discounts. Therefore eight large consumers and four wholesalers of coal brought suit for a temporary injunction on the ground that the execution of the cartel resolution violated Article 65 of the Coal-Steel Community Treaty. The court ruled that the complaint was subject to dismissal for the

der Montanunion, 17 ZEITSCHR. F. AUSL. & INTERN. PRIVATRECHT, 325 at 359 (1952); KRAWIELICKI, DAS MONOPOLVERBOT IM SCHUMANPLAN, 44 (1952); Matthies, *Das Recht der Europäischen Gemeinschaft für Kohle und Stahl und die nationalen Gerichte der Mitgliedstaaten*, 9 JURISTENZEITUNG 305 (1959); BALLERSTEDT, ÜBERNATIONALE UND NATIONALE MARKTORDNUNG (1955); Steindorff, *Der Begriff der Preisdiskriminierung im Recht der EGKS*, 21 ZEITSCHR. F. AUSL. & INTERN. PRIVATRECHT, 270 at 317 (1956); Mylord, *Zur Frage des Rechtsschutzes "Dritter" im Rechtssystem der EGKS*, 7 WUW 483, at 485 (1957).

⁵⁴⁹ Art. 65(4) para. 2. In addition art. 41 provides that only the Court of Justice may decide on the validity of actions of the High Authority, if such validity is challenged in a litigation pending before a national tribunal.

⁵⁵⁰ Art. 65(4) para. 2 does not mention concerted practices in addition to agreements and decisions, but this omission apparently is only an oversight of the draftsmen.

⁵⁵¹ City of Stuttgart et al. v. Oberrheinische Kohlenunion, judgment of Landgericht Stuttgart, Aug. 10, 1953, reprinted in 4 WUW 140 (1954); Sirey, Jur. Part IV, 1 (1954), with note by Philonenko.

reason that Article 65 required a decision by the High Authority on the merits and that prior to such determination a national court could not grant temporary relief.⁵⁵²

(2) *Implementation and supplementation by national laws.* The rule that deprives a national tribunal of jurisdiction for determining whether or not an enterprise has engaged in anticompetitive practice does not, of itself, bar such a court from imposing civil liability on any enterprise either after the High Authority has found the same to be in violation of the prohibitions of Article 65 or if such violation is not contested. The Treaty is silent as to the possible tort liability for contraventions against Article 65. Thus the questions arise as to whether the national legal systems *may* attach and actually *have* attached civil liability to the perpetration of the anticompetitive practices as defined and prohibited by the Treaty.

There is nothing in the general policy of the Treaty which would support a conclusion to the effect that a member state is forbidden to declare a violation of the prohibitions of Article 65 to be a tort rendering the perpetrator liable in damages, so long as the imposition of such liability is not discriminatory.⁵⁵³ The problem therefore reduces itself to the question whether the national legal systems actually should be interpreted that way. The answer, of course, may vary according to which one of the six national legal systems is involved.

In German law, for instance, liability in damages of a violator of the mandates of Article 65 (1) conceivably could be based on one of four broad and overlapping categories of torts:

- 1) intentional or negligent invasion of the absolute right of a person to his established and conducted enterprise (Civil Code, Section 823 I);⁵⁵⁴

⁵⁵² Actually the court requested a determination by the High Authority, but the latter replied that its investigation was still in process. The High Authority, in fact, did not approve the cartel until 1957, and then only after drastic structural changes, Decision No. 19-57, July 26, 1957, [1957] J'L OFF. 352. For the subsequent history of the status of this purchase cartel see E.C.S.C. High Authority, EIGHTH GENERAL REPORT 192 (1960).

⁵⁵³ Accord REUTER, LA COMMUNAUTÉ EUROPÉENNE DU CHARBON ET DE L'ACIER 214 (1953); Matthies, *Das Recht der Europäischen Gemeinschaft für Kohle und Stahl und die nationalen Gerichte der Mitgliedstaaten*, 9 JURISTENZEITUNG 305, at 307 (1954); Steindorff, *Der Begriff der Preisdiskriminierung im Rechte der EGKS*, 21 ZEITSCHR. F. AUSL. & INT. PRIVATRECHT 270, at 317 (1956); Roblot, *Les relations privées des entreprises assujetties à la C.E.C.A.*, 17 DROIT SOCIAL 561, at 567 and 574 (1954).

⁵⁵⁴ About this tort under German law see 2 RGR Kommentar zum BGB § 823 Anm.

- 2) intentional or negligent violation of a law enacted for the protection of others (Civil Code, Section 823 II);
- 3) intentional and unethical infliction of damages (Civil Code, Section 826);
- 4) unethical business conduct for purposes of competition (Law against Unfair Competition, 1909, Section 1).

Similarly, in France, Belgium, and Luxembourg such liability would result if engaging in anticompetitive practices contrary to the Treaty were deemed to fall within the sweeping contours of tortious conduct marked by the French Civil Code, Articles 1382 and 1383.⁵⁵⁵

There is some judicial authority supporting such results. In Germany the District Court of Stuttgart, in the aforementioned decision of 1953,⁵⁵⁶ stated, by way of dictum, that a cartel action, taken in violation of Coal-Steel Community Treaty Article 65, entitles injured parties to damages under Sections 823 I and 823 II of the German Civil Code. A similar conclusion was reached by the District Court of Essen in an order of November 4, 1953.⁵⁵⁷ That case arose as a consequence of a resolution of the then-existing six sales agencies for Ruhr coal which decided to discontinue the direct supplying of wholesale coal dealers having an annual sales volume of less than 48,000 tons. An aggrieved dealer brought suit for declaratory judgment to the effect that the challenged action entitled him to damages. The Court conceded that damages could be demanded if the action in question violated the prohibitions of Article 65 and continued the proceedings⁵⁵⁸ until a determination of this question by the High Authority.⁵⁵⁹

However, more recent and authoritative judicial authority has shown reluctance to consider every prohibition of the Treaty to be a law for the protection of others within the meaning of Section 823 II of the German Civil Code. In a far-reaching decision of April

9 (10th ed. 1953). For recent decisions by the German Supreme Court see 12 NJW 479 (1959); 12 NJW 934 (1959).

⁵⁵⁵ This conclusion is adopted as correct by Roblot, *op. cit. supra* note 553, at 574, text at n. 75; see in general Roubier, *Théorie générale de l'action en concurrence déloyale*, 1 REV. TRIM. DE DR. COMM. 541 (1948).

⁵⁵⁶ *Supra* note 551.

⁵⁵⁷ 8 BETRIEBS-BERATER 991 (1953).

⁵⁵⁸ The decision is criticized on that score by Spengler, *Abgrenzungsfragen aus der Übergangszone zwischen Kartell- und Montanunions-Recht*, 4 WuW 753, at 768 (1954).

⁵⁵⁹ The High Authority declared the prohibitions to be inapplicable and its determination was sustained by the Court of Justice, see *supra* note 537.

14, 1959,⁵⁶⁰ the German Supreme Court held that the prohibitions against price discriminations, contained in Articles 4(b) and 60(1) of the Coal-Steel Community Treaty, do not constitute laws for the protection of the injured customers or competitors within the meaning of Section 823 II of the German Civil Code. A similar question confronted the Court of Appeals of Celle⁵⁶¹ in a suit instituted by a wholesale dealer in lignite against the sales subsidiary of a lignite producer as a result of the latter's determination to discontinue a direct supply of the plaintiff and to accord exclusive sales franchises to other dealers. The Court left open the question of whether the plaintiff was entitled to relief in a national tribunal as a result of a violation of Coal-Steel Community Treaty Article 4b and determined the litigation on the basis of the provisions of the German Law against Restraint of Trade, in particular those governing enterprises with dominant market position.

The latter Court thus proceeded on the theory that the national laws against anticompetitive practices remain applicable to the enterprises subject to the discipline of the Coal-Steel Community Treaty so long as there is no conflict between the two sets of rules. Absence of tort liability under national law for violations of the prohibitions of Article 65 accordingly would not mean freedom from any liability, if, and to the extent that, such conduct is also in contravention of national legislation.

C. PROTECTION AGAINST ECONOMIC CONCENTRATION AND MISUSE OF DOMINANT MARKET POWER

I. CONTROL OF NEW CONCENTRATIONS

a. *Genesis and Purpose of Article 66*

As has been mentioned before, the Treaty includes not only prohibitions against cartelization and concerted practices (Article 65) but, in addition, contains provisions designed (a) to curb new concentration of economic power through total or partial integration of enterprises (Article 66(1-6)), and (b) to suppress misuses of dominant market power by enterprises which have or acquire such position (Article 66(7)).

⁵⁶⁰ 30 BGHZ 74 (1959). The decision is criticized by Janssen van Raay, *Een beslissing van het Bundesgerichtshof over E.G.K.S.-recht*, [1960] NEDERLANDS JURISTENBLAD 437.

⁵⁶¹ Court of Appeals of Celle, Sept. 1, 1958, 9 WUW 290 (1959).

Provisions for administrative control of misuses of dominant market power, such as are contained in the last section of Article 66, were traditional with some of the European antitrust legislation and could be found in the German Cartel Ordinance of 1923 and the Dutch Cartel Ordinance of 1941, as amended in 1942.⁵⁶² Their inclusion in the market discipline of the Treaty, therefore, was not novel.

Limitations on economic concentration by integration, however, were unknown to European cartel legislation and were inserted in the framework of the Treaty, at least in a large measure, it seems, upon the insistence of the Allied Occupation Authorities in Germany who desired a legal palliative against future untrammelled reconcentration in the German coal and steel industry, which had been subjected to drastic deconcentration just at the time of the negotiations of the Coal-Steel Community Treaty.⁵⁶³

The Treaty did not aim at a re-structuring of the common market as it existed at the time the Treaty became operative, but it subjects any *new* concentration of enterprises to the control of the Community agencies, thus forestalling the formation of giants with market power deemed to be excessive.

b. *Method and Scope of Control*

(1) *Form of control in general.* Article 66(1) of the Treaty requires prior approval by the High Authority for every transaction which, directly or indirectly, effectuates within the common market a concentration, as understood by the Treaty, involving at least one enterprise that is engaged in coal or steel production or in distribution except retail trade. Article 66(2) makes it mandatory for the High Authority to grant such approval, unless the ensuing concentration gives the enterprises involved excessive power over the market according to a set of criteria specified by the Treaty. The High Authority is empowered by Article 66(1) to determine, by way of regulation, the factors which constitute control for the purposes of a concentration within the meaning of that Article. Moreover, the High Authority, by way of regulation, may also exempt

⁵⁶² See *supra* part II, sections A and C.

⁵⁶³ See *supra* text at note 509. For a discussion of the deconcentration of the West German coal and steel industry under Allied High Commission Law No. 27 of May 16, 1950 (AHC Off. Gaz. No. 20, 299) and the interrelation between this program and the negotiation and ratification of the E.C.S.C. Treaty see Office of the U.S. High Commissioner for Germany [FINAL] REPORT ON GERMANY, 1949-1952, at 108-113 (1952); Office of the U.S. High Commissioner for Germany, 6TH QUARTERLY REPORT, 83 (1951); 7TH QUARTERLY REPORT, 15, 52, 109 (1951).

certain types of transactions resulting in concentration from the requirement of prior approval if their effects are certain not to be harmful to competition (Article 66(3)). The High Authority has issued regulations both as envisaged by Article 66(1) ⁵⁶⁴ and Article 66(3). ⁵⁶⁵

(2) *Concept of concentration within the meaning of Article 66; scope of applicability.* Unfortunately Article 66 does not contain a direct definition of the concept of concentration. However, it is possible to glean its criteria from various elements of that complex provision. Accordingly, a concentration within the meaning of the Treaty (a) occurs "*between enterprises*," one of which must be a producer of or wholesale dealer in coal and steel products, (b) is the direct or indirect effect, within the common market territory, of an *operation* consisting in the act of a person or enterprise, or a group of persons or enterprises, (c) is accomplished *by* merger, acquisition of stock or assets, loan, contract, or other *means of control*. The essence of concentration, then, is the establishment of a common control over the equipment or management of an enterprise subject to the general discipline of the Treaty and that of another enterprise operating in the common market. ⁵⁶⁶ The concept includes cases of both horizontal and vertical arrangements.

The High Authority, with the advice of the Council of Ministers, has issued a detailed regulation specifying the proprietary or contractual arrangements which, under appropriate factual conditions, may confer power to control production, pricing investments, procurement, sales, or distribution of profits and thus constitute elements of control as envisaged in the definition of concentration. ⁵⁶⁷ The acquisition of stock by banks in connection with the formation of corporations or the issuance of new stock for purposes of resale does not constitute control as long as the right to vote such shares remains unexercised. ⁵⁶⁸

⁵⁶⁴ Decision No. 24-54, May 6, 1954, [1954] J'L OFF. 345.

⁵⁶⁵ Decision No. 25-54, May 6, 1954, and No. 28-54, May 26, 1954, [1954] J'L OFF. 346, 381.

⁵⁶⁶ For a discussion of the concept of concentration see also KRAWIELICKI, *DAS MONOPOLVERBOT IM SCHUMAN-PLAN*, 55 (1952); REUTER, *LA COMMUNAUTÉ EUROPÉENNE DU CHARBON ET DE L'ACIER*, 215 (1953); Roblot, *Les relations privées des entreprises assujetties à la C.E.C.A.*, 17 DROIT SOCIAL, 561 at 575 (1954); Prieur, *The Concept of the Concentration of Enterprises within the Meaning of art. 66 of the E.C.S.C. Treaty*, 82 JOURN. DU DROIT INTERNATIONAL, 807 (1955); KERN, *DAS RECHT DER UNTERNEHMENSZUSAMMENSCHLÜSSE IN DER MONTANUNION* 37 (1955), review thereof by Jerusalem, 8 NJW 1430 (1955).

⁵⁶⁷ Decision 24-54, [1954] J'L OFF. 345 and comments thereon, Prieur, *op. cit. supra* note 566, at 817 (1955); Kern, *op. cit. supra* note 566, at 52.

⁵⁶⁸ Decision 24-54, art. 2, [1954] J'L OFF. 345.

Article 66(1) requires previous approval for "operations" effecting concentration. The question has been posed whether concentrations resulting from an operation of law, such as intestate succession, are included within this term or whether it is equivalent with, and limited to, the concept of transaction. Authors who have taken the former view have pointed out that in any case the acceptance of the inheritance may be subject to prior approval.⁵⁶⁹ The controversy obviously will require final resolution by the Court.

Apart from exceptions no longer material, the regime of the Treaty applies only to *new* concentrations, *i.e.*, operations taking effect after the date at which the Treaty went into force. The requirement of prior approval, moreover, affects only transactions subsequent to the promulgation of the pertinent regulation.⁵⁷⁰

(3) *Conditions for refusal of approval.* The grant of the approval is mandatory unless the High Authority finds that the contemplated concentration affords the participants excessive market power with respect to products subject to its jurisdiction. That condition is deemed to exist if the parties are capable either (a) of determining the price, of controlling or restricting the production or distribution, or hindering the maintenance of an effective competition, in a significant part of the market for such products, or (b) of escaping the Treaty rules governing competition, especially through the establishment of an artificial position of privilege which affords a substantial advantage in the access to sources of supply or outlets.⁵⁷¹

The Treaty provides expressly that the High Authority, in making the requisite determination, is bound to observe the basic principle of non-discrimination and therefore to take account of the size of other enterprises of the same type operating in the Community, to the extent that it considers justified in order to avoid or correct disadvantages which flow from a disparity in competitive position.⁵⁷²

In practice the High Authority has exercised its powers over concentrations with extreme caution and in a restrained case-by-case approach. Up to the present it has seen no occasion for refusing any of the applications processed so far.⁵⁷³ As a result the Common As-

⁵⁶⁹ REUTER, *op. cit. supra* note 566, at 216; Roblot, *op. cit. supra* note 566, at 575. *Contra* KRAWIELICKI, *op. cit. supra* note 566, at 57. That author, however, concedes that a concentration by operation of law may be subject to the High Authority's power of deconcentration under art. 66(5)(2).

⁵⁷⁰ Convention on Transitional Provisions sec. 13, paras. 1 & 2.

⁵⁷¹ Art. 66(2) para. 1.

⁵⁷² Art. 66(2) para. 2.

⁵⁷³ See the survey in the High Authority, EIGHTH GENERAL REPORT OF THE ACTIVITIES OF THE COMMUNITY, 203 (1960). For an exposé of the criteria applied by the High Authority in the disposition of applications for authorization of concentrations see its reply to the written interpellation No. 21-60 [1960] J'L OFF. 1078.

sembly has pressed for the development of a more articulate and energetic policy in that field.⁵⁷⁴ The pending application for authorization of a concentration reuniting August Thyssen Hütte AG and Phoenix-Rheinrohr AG (the two most important enterprises carved from the former Thyssen combine), however, has met with considerable opposition from the High Authority.

c. *Enforcement and Sanctions*

Article 66 accords the High Authority broad powers of investigation⁵⁷⁵ and of enforcing the observance of the discipline of the Treaty with respect to concentrations.⁵⁷⁶ Article 66(5) differentiates between two categories of concentrations accomplished in contravention to the provisions of the Treaty: (a) those which are *irregular* because they lack the requisite prior authorization but for which such authorization would have been mandatory; (b) those which are *illegal* because they result in excessive market power as defined by Article 66(2).

In the first alternative the primary sanctions consist of fines imposed upon the persons responsible for the operation. The maximum amounts of these fines are fixed by Article 66(6). Only if the fines remain unpaid, may the High Authority proceed to deconcentration of the enterprises involved in the irregular concentration.

In the second alternative the High Authority must first make a finding as to the excessive market power resulting from the concentration. After a hearing which permits the interested parties to present their arguments the High Authority may order the steps appropriate for severing the concentration and restoring the normal conditions of competition, such as divorcement, dissolution, and divestiture. In case of non-compliance with its mandates the High Authority itself may proceed to the execution of the measures specified, by making the appropriate orders or requesting the appointment of a receiver.

The determinations of the High Authority are subject to the usual review by the Community Court, with the qualification, however, that there is an appraisal *de novo* on the issue of excessiveness of the resulting market power.⁵⁷⁷

⁵⁷⁴ The policy of the High Authority has been reviewed in two successive reports on the concentration of enterprises in the Community by members of the Common Assembly for the later's Commission: viz. by Mr. Henry Fayat, Common Assembly, Doc. No. 26 (1956-1957) and by Mr. Lapie, Common Assembly, Doc. No. 16 (1957-1958).

⁵⁷⁵ Art. 66(4).

⁵⁷⁶ Art. 66(5).

⁵⁷⁷ Art. 66(5) para. 2.

In the case of unauthorized concentrations the Treaty refrains from ordaining nullity *ab initio*, as it does in the case of cartels and other restrictive agreements.

2. CONTROL OF THE CONDUCT OF ENTERPRISES WITH DOMINANT MARKET POWER

Since Article 65 applies only to collective practices and since Article 66(1-6) concerns only new concentrations, the framers of the Treaty felt that additional safeguards for the competitive mechanism of the market were necessary with respect to anticompetitive practices by single enterprises with dominant market power which had attained this status either by unassailable pre-Treaty concentration or had acquired or were going to acquire it in a manner other than by concentration. As has been mentioned before, such approach corresponds to significant precedents in European cartel legislation.

Accordingly, Article 66(7) grants the High Authority additional powers over enterprises in the coal and steel industry, whether public or private, which by reason of legal or factual circumstances possess a dominant position with respect to their products in a significant part of the common market. If such enterprises engage in practices which are inconsistent with the basic policies of the Coal-Steel Community Treaty, such as the principle against non-discrimination, the High Authority may address appropriate recommendations for remedying the situation to the enterprise in question.⁵⁷⁸ If the latter persists in its conduct, the High Authority may impose upon it specific rules for doing business.

D. PROTECTION AGAINST GOVERNMENT INTERFERENCE

As has been pointed out above in Section B, 1a(1), the Treaty not only protects the common market against anticompetitive practices by *enterprises* but also liberates and shields it from *governmental* measures that interfere with the forces of competition. One of the bases of action by Community organs in such cases, though somewhat perplexing in scope and modest in thrust, is Article 67.

⁵⁷⁸ A famous instance of a recommendation under art. 66(7) was that of July 11, 1953, [1953] J'L OFF. 154, directed to the Oberrheinische Kohlenunion, the exclusive distributor for South and Southwest Germany of coal produced in the Ruhr, Saar, Lorraine and Aix-la-Chapelle districts. It recommended to take all measures proper to prevent practices contrary to art. 4. The addressee was a cartel which possessed a dominant position in the market, but held a lease on life until the termination of proceedings under art. 65 by virtue of sec. 12 of the Convention on Transitional Provisions, see *supra* text at note 537. See also notes 551 and 557.

This article concerns itself with "measures of member states that are capable of exerting substantial influence upon the competitive conditions in the coal industry." The Treaty differentiates between two great classes of such measures:

- (a) those which are capable of producing severe economic imbalance by significantly *augmenting* the differences in production costs in a manner other than by increasing productivity;
- (b) those which *decrease* the differences in production costs by according special advantages to or imposing special burdens upon domestic coal and steel enterprises as compared with other domestic industries.

In cases of interferences of the latter type the High Authority is authorized, after having consulted with the Council and the Consultative Committee, to address the appropriate recommendations to the respective state.^{578a}

Another and seemingly much more comprehensive and effective source of power for the Community organs is Article 88 of the Treaty. It authorizes the High Authority to initiate certain proceedings and take certain measures whenever it finds that a member state has failed to live up to its treaty obligations and, in particular, to observe the sweeping mandates of Articles 2-4. The High Authority has resorted to the procedure under Article 88 in two cases involving official, or officially sanctioned, organisms possessing a monopoly over coal imports, the Office Commercial du Ravitaillement in Luxembourg and A.T.I.C. in France. The former controversy became moot when the Luxemburgian government rescinded the provisions governing the importation of solid fuels.^{578b} The A.T.I.C. dispute is still in the stage of negotiations between France and the High Authority^{578c} and has involved the latter in a damage suit brought by a Belgian dealer on the ground that the High Authority has failed to perform an official duty.^{578d}

^{578a} For a more detailed discussion of the purpose and scope of Article 67, see Reuter, *op. cit. supra* note 566, 196.

^{578b} See E.C.S.C., High Authority, SIXTH GENERAL REPORT 92 (1958).

^{578c} See *supra* note 185 and E.C.S.C., High Authority, EIGHTH GENERAL REPORT 195 (1960).

^{578d} Société Commerciale A. Vloeberghs S.A. c. Haute Autorité, [1960] J'l Off. 808.

IV. THE PROTECTION OF COMPETITION IN THE EUROPEAN ECONOMIC COMMUNITY

A. THE PROTECTION OF COMPETITION WITHIN THE GENERAL FRAMEWORK OF THE COMMUNITY STRUCTURE

I. FUNDAMENTAL ASPECTS OF THE GENERAL EUROPEAN COMMON MARKET

a. *From the European Coal and Steel Community to the European Economic Community*

(1) *Functional and institutional changes in Community organization.* When the governments of the six nations forming the European Coal and Steel Community decided ⁵⁷⁹ to take the long step from a partial economic integration, restricted to the coal and steel industry, to a general economic integration encompassing the whole field of production and distribution, by the establishment of a new European Economic Community, it became clear that the pattern of the Coal-Steel Community Treaty would have to be significantly modified, both as to functional and institutional aspects. While a detailed comparison of the legal framework of the two communities would go far beyond the scope of this discussion,⁵⁸⁰ it is necessary to underscore a few basic likenesses and differences.

There is no question that the architects of the new European Economic Community relied heavily on the experience and structure of the European Coal and Steel Community as the starting point for their blueprint. As Professor Reuter has put it so adroitly: "In

⁵⁷⁹ For the background of this decision, see *supra* Introduction.

⁵⁸⁰ For a general discussion of the politico-economic and legal structure of E.E.C. (with or without comparison with E.C.S.C. and Euratom), see Carstens, *Die Errichtung des gemeinsamen Marktes in der Europäischen Wirtschaftsgemeinschaft, Atomgemeinschaft und Gemeinschaft für Kohle und Stahl*, 18 ZEITSCHRIFT FÜR AUSLÄNDISCHES ÖFFENTLICHES RECHT UND VÖLKERRECHT 459 (1958); Catalano, *LA COMUNITÀ ECONOMICA EUROPEA E L'EURATOM* (1957); Reuter, *Aspects de la Communauté Economique Européenne*, 1958 REVUE DU MARCHÉ COMMUN, 6 (No. 1), 161 (No. 3), 310 (No. 6); Soulé, *Comparaison entre les dispositions institutionnelles du Traité CEEA et du Traité CEE*, 1958 REVUE DU MARCHÉ COMMUN, 95 (No. 2), 208 (No. 4); *Le Marché Commun et ses problèmes*, 1958 REVUE D'ECONOMIE POLITIQUE, Numéro Spécial; *Les Aspects Juridiques du Marché Commun*, 8 COLL. SCIENTIFIQUE DE LA FACULTÉ DE DROIT DE L'UNIV. DE LIÈGE (1958); *Aspects du Marché Commun*, 3 BIBLIOTHÈQUE DE LA SOCIÉTÉ ROYALE D'ECONOMIE POLITIQUE DE BELGE (1958). For an article-by-article explanation of the Treaty see von der Groeben and von Boeckh, *KOMMENTAR ZUM EWG-VERTRAG*, (2 vols. 1958, 1960); WOHLFAHRT, EVERLING, GLAESNER, SPRUNG, *DIE EUROPÄISCHE WIRTSCHAFTSGEMEINSCHAFT, KOMMENTAR ZUM VERTRAG* (1960).

a large measure E.E.C. is an extrapolation of the European Coal and Steel Community.”⁵⁸¹ Both organizations are fashioned as Communities of the member nations;⁵⁸² both Communities depend upon the institution of a common market, *i.e.*, a market freed from all national barriers, at least against a free circulation of goods⁵⁸³ as a principal means for the attainment of the community goals.

However, while the common market is the “basis” and sole mechanism of the Coal-Steel Community,⁵⁸⁴ the E.E.C. Treaty adds the gradual approximation of the economic policies of the member states as an additional instrument of E.E.C.⁵⁸⁵ Moreover, the common market of E.E.C. is surrounded by a uniform customs wall⁵⁸⁶ and developed by a common commercial policy vis-à-vis other nations,⁵⁸⁷ while the Coal-Steel Community does not provide for such an arrangement.⁵⁸⁸ Conversely, only the Coal-Steel Community Treaty accords the Community agencies extensive “dirigistic” or regulatory powers over the market in circumstances where economic developments render a reliance on its auto-mechanism unfeasible.⁵⁸⁹ The E.E.C. Treaty does not duplicate this scheme and entrusts the Community, acting through the Council of Ministers, only with few and narrowly circumscribed direct powers of economic control.⁵⁹⁰

Needless to say, these changes in function were caused not only by the differences in economic structure and magnitude of the two markets, but also, and perhaps primarily, by the realistic respect of the drafters for national sensitivities, the resurgence of economic liberalism, and certain other developments in the general political climate.⁵⁹¹ The same considerations produced corresponding modifications in the institutional framework. The framers of the new Treaty avoided provocative terms such as “supranational” or “High

⁵⁸¹ Reuter, *op. cit. supra* note 580, at 8.

⁵⁸² E.C.S.C. Treaty art. 1; E.E.C. Treaty art. 1; *cf.* Carstens, *op. cit. supra* note 580, at 460.

⁵⁸³ About the relativity of the notion of a common market, see also Carstens, *op. cit. supra* note 580, at 460.

⁵⁸⁴ E.C.S.C. Treaty arts. 1 and 2 para. 1.

⁵⁸⁵ E.E.C. Treaty art. 2. While, accordingly, the economic policies of the states are to be “harmonized,” but, generally speaking, remain within the province of the individual states, a more extensive integration is adopted with respect to foreign commerce. It is to become a matter of Community policy at the end of the transitional period, E.E.C. Treaty, art. 111. See Carstens, *op. cit. supra* note 580, at 495, 497, and 507, but contrast the skeptical comments by Reuter, *op. cit. supra* note 580, at 9.

⁵⁸⁶ E.E.C. Treaty arts. 18-29.

⁵⁸⁷ E.E.C. Treaty arts. 110, 116.

⁵⁸⁸ E.C.S.C. Treaty art. 72.

⁵⁸⁹ *E.g.* E.C.S.C. Treaty art. 59.

⁵⁹⁰ *E.g.* E.E.C. Treaty art. 103.

⁵⁹¹ See the discussion by Reuter, *op. cit. supra* note 580, at 9 and 11.

Authority" and strengthened the participation of both the Council of Ministers and the Assembly, transforming at the same time the role of the Commission.⁵⁹²

(2) *Changes in the normative technique of the respective treaties.* The difference in scale of the two markets and the impossibility of foreseeing and providing with precision all economic measures that might become necessary in the larger setting, no less than the exigencies of political realities, resulted also in a significant change in the normative technique employed by the framers of the E.E.C. Treaty from that utilized by the draftsmen of the older instrument. The E.E.C. Treaty, much more than the Coal-Steel Community Treaty, is merely a "framework treaty."⁵⁹³ In many of its portions it is confined to a stipulation of programs and principles, leaving the implementation to further normative procedures by the Community agencies, in particular by the Council of Ministers. In other words, the E.E.C. Treaty is of much lesser normative "density" than its counterpart of more ancient vintage. Accordingly, the E.E.C. Treaty relies to a much greater extent than the Coal-Steel Community Treaty on legislative or, at least, quasi-legislative action by the Council⁵⁹⁴ which, as the case may require, is either directly applicable to individuals or requires further concretization by legislation on the part of the Member States.⁵⁹⁵ Corresponding to this change in normative technique is a significant modification in terminology evident from a comparison between Coal-Steel Community Treaty, Article 14, and E.E.C. Treaty, Article 189. The latter expressly adds the further categories of "regulations" and "directives" to the categories of decisions, recommendations, and opinions defined by the former.

b. *Legal Characteristics of the Common Market*

(1) *Unification without uniformization.* The legal nature of the Common Market depends in the first place and most of

⁵⁹² See Soulé, *op. cit. supra* note 580, at 98 (comparison of the respective functions of the Councils of Ministers, of the High Authority, and of the Commission), 100 (comparison of the roles of the Assembly); Reuter, *op. cit. supra* note 580, at 310; Catalano, *op. cit. supra* note 580, at 19-32. For the position of the Court of Justice, see Daig, *Die Gerichtsbarkeit in der Europäischen Wirtschaftsgemeinschaft und der Europäischen Atomgemeinschaft mit vergleichenden Hinweisen auf die Europäische Gemeinschaft für Kohle und Stahl*, 83 ARCH. ÖFF. R. 132 (1958).

⁵⁹³ Reuter, *op. cit. supra* note 580, at 161.

⁵⁹⁴ See Reuter, *op. cit. supra* note 580, at 161; Meibom, *Die Rechtsetzung durch die Organe der Europäischen Gemeinschaften*, 14 BETRIEBS-BERATER, 127 (1959); Everling, *Die ersten Rechtssetzungsakte der Organe der Europäischen Gemeinschaften*, 14 BETRIEBS-BERATER, 52 (1959).

⁵⁹⁵ E.E.C. Treaty art. 189, paras. 2 and 3.

all on the character and degree of integration of the Community which it serves. As has been stated before, the objective of the Treaty of Rome is the achievement of European integration on a predominantly economic rather than on a primarily political level. Thus, the European Economic Community "is founded upon a customs union,"⁵⁹⁶ entailing a fusion of the markets included therein, but without exhausting itself solely in that feature. Rather the Common Market, as instituted, is to evolve under the aegis of a common and unified commercial policy⁵⁹⁷ and of harmonized policies of the Member States covering other economic matters.⁵⁹⁸ In other words, in the latter respects the individual Member States retain their separate though greatly tempered jurisdictions.⁵⁹⁹ Accordingly, the Common Market is conceived as a unified but, speaking legally, not uniform market.

The fusion of the markets is to be achieved by a successive removal of all internal barriers against (a) the free exchange of goods,⁶⁰⁰ (b) the mobility of the labor force,⁶⁰¹ (c) the exercise of a trade by citizens of the other Member States,⁶⁰² (d) the right to work of non-resident citizens of the other Member States,⁶⁰³ and (e) the transfer of capital from one Member State to another.⁶⁰⁴ The Common Market includes agriculture, but the Treaty establishes a separate discipline for that sector.⁶⁰⁵ The coherence of the Common Market is safeguarded by provisions for a common transportation policy.⁶⁰⁶ However, the Treaty has not unified the currency of the Member States.

(2) *Reliance on the auto-mechanism of the market.* The discipline of the Common Market, especially after the expiration of the transitional period, is inspired by a liberalistic approach.⁶⁰⁷ The market is to be shaped by its own auto-mechanism as governed by the forces of normal competition. Therefore, the framers of the Treaty concentrated primarily on the removal of obstacles to, and

⁵⁹⁶ E.E.C. Treaty art. 9.

⁵⁹⁷ E.E.C. Treaty art. 110, para. 2, art. 111(1); see Carstens, *op. cit. supra* note 580, at 495-500.

⁵⁹⁸ E.E.C. Treaty arts. 2, 104, 145; see also art. 103 (policies regarding cyclical fluctuations) and art. 105 (policies regarding currency questions).

⁵⁹⁹ See Carstens, *op. cit. supra* note 580, at 497, 498.

⁶⁰⁰ E.E.C. Treaty arts. 12-17, 30-37.

⁶⁰¹ E.E.C. Treaty arts. 48-51.

⁶⁰² E.E.C. Treaty arts. 52-58.

⁶⁰³ E.E.C. Treaty arts. 59-66.

⁶⁰⁴ E.E.C. Treaty arts. 67-73.

⁶⁰⁵ E.E.C. Treaty arts. 38-47.

⁶⁰⁶ E.E.C. Treaty arts. 74-84.

⁶⁰⁷ See Reuter, *op. cit. supra* note 580, at 11.

the protection of, sound competition. Only a few cautious provisions permit direct Community intervention in the processes of the market. The establishment of the European Investment Bank, formed by the Member States,⁶⁰⁸ and the creation of the European Social Fund⁶⁰⁹ may be cited as mild forms of "dirigistic" tendencies. Powers to take more drastic measures are conferred only with vague contours in the matrix of the provisions for the development of concordant policy by the individual states with respect to cyclical fluctuations.⁶¹⁰

2. PATTERN OF THE PROTECTION OF COMPETITION IN THE E.E.C. TREATY

a. *Structure and Interrelation of the Treaty Provisions in General*

Since the European Economic Community relies so preponderantly on the competitive auto-mechanism of the Common Market for its progress and the achievement of its aims, the framers of the Treaty took particular pains in providing for appropriate conditions and safeguards needed to assure a proper functioning of the competitive process.

Not only does Article 3(f) specify that one of the principal activities of the Community consists in "the establishment of a regime which assures that competition in the Common Market is not adulterated," but this program is implemented by a series of detailed provisions to that effect. It may even be, as Professor Reuter claims,⁶¹¹ that the drafters have belabored this subject too much and that their afterthoughts have resulted in defective formulations.

Theory and arrangement of the Treaty proceed on the basis that such deleterious restraints or adulterations of competition may result either (a) from anticompetitive practices engaged in by private or public enterprises operating in the market, or (b) from direct and open restrictions or discriminatory burdens imposed, or competitive advantages granted, by the Member States, or (c) repercussions on the market structure of existing or contemplated differences and inequalities in the general legal systems of the Member States. Accordingly, the Treaty contains not only regulations per-

⁶⁰⁸ E.E.C. Treaty arts. 129, 130.

⁶⁰⁹ E.E.C. Treaty arts. 123-128.

⁶¹⁰ E.E.C. Treaty art. 103.

⁶¹¹ See Reuter, *op. cit. supra* note 580, at 8.

taining to anticompetitive *practices* by enterprises,⁶¹² but, in addition, an array of provisions dealing with anticompetitive *measures* by the Member States relating to public enterprises or enterprises with special franchises,⁶¹³ dumping,⁶¹⁴ state subsidies,⁶¹⁵ discriminatory exactions,⁶¹⁶ and harmonizations of the legal systems.⁶¹⁷

This list shows in stark relief that the anticompetitive practices by enterprises are only one facet of the total legal framework designed to assure a common market with a truly competitive mechanism and that the major preoccupations of the framers of the Treaty focused on the distortions of the competitive process resulting from specific measures of the Member States or from the repercussions of the divergencies in the different national legal systems. Needless to say, the comprehensive scope of the provisions and, at the same time, delicate task of protecting competition in the Common Market is reflected in the activities and attitudes of the Community agencies.⁶¹⁸

b. *Protection of Competition and Protection Against Discrimination*

Protection of competition and protection against economic discrimination are twin policies, although, on occasion, they may come into perplexing conflict, as any person familiar with American anti-trust law will confirm. It is, therefore, no surprise that the Treaty intertwines the two principles. However, it does not lay down a broad proscription of *all* discriminations of an economic nature. On the one hand, it elevates the prohibition against discrimination *on grounds of nationality* to one of the cardinal principles of the Community⁶¹⁹ and reiterates it specifically with respect to state measures relative to (a) the supply of consumers by commercial state monopolies⁶²⁰ and (b) activities of public enterprises and enterprises with

⁶¹² E.E.C. Treaty arts. 85-89.

⁶¹³ E.E.C. Treaty arts. 90 and 37.

⁶¹⁴ E.E.C. Treaty art. 91.

⁶¹⁵ E.E.C. Treaty arts. 92-94.

⁶¹⁶ E.E.C. Treaty arts. 95-99.

⁶¹⁷ E.E.C. Treaty arts. 100-102.

⁶¹⁸ See especially von der Groeben, *Problèmes de la politique européenne de concurrence*, [1960] BULLETIN DE LA CEE No. 3, at 5. Verloren van Themaat, *Fünf Grundsätze der europäischen Wirtschaftspolitik*, 2 EUROPÄISCHE WIRTSCHAFT 535 (1959); Verloren van Themaat, *Competition and Restrictive Business Practices in the European Economic Community*, FEDERAL BAR ASS'N. INSTITUTE ON LEGAL ASPECTS OF THE EUROPEAN COMMUNITY 99 (1960).

⁶¹⁹ E.E.C. Treaty art. 7, para. 1.

⁶²⁰ E.E.C. Treaty art. 37(1).

special franchises.⁶²¹ On the other hand, the Treaty contains only a few cautious prohibitions against other discriminatory practices of economic import, that is, prohibitions against the imposition of discriminatory business terms on sellers or buyers either by enterprises acting in concert⁶²² or by enterprises with dominant positions in the market.⁶²³

*c. Comparison of the Protection of Competition in
the E.E.C. and Coal-Steel Community*

In comparing the structure and form of the protection of competition in the E.E.C. Treaty with that of the Coal-Steel Community Treaty, a few basic points become evident. On the one hand, the pattern and formulation of a number of the respective provisions in the two Treaties have many common traits and, accordingly, present analogous problems of interpretation and application. On the other hand, there are marked fundamental differences. The E.E.C. Treaty, because of the comprehensive scope of the market and the abstention from vesting vast overriding powers over the market in the Community organs, focuses much more than the Coal-Steel Community Treaty on all facets of a balanced basis for competition. Conversely, the E.E.C. Treaty attributes a somewhat more modest range to the principle of non-discrimination⁶²⁴ and deletes all barriers against economic concentrations, confining itself merely to the control of abuses of monopoly power.

B. THE PROTECTION OF COMPETITION AGAINST COLLECTIVE ANTICOMPETITIVE CONDUCT OF ENTERPRISES

I. STRUCTURE, APPLICABILITY, AND SCOPE OF THE PROHIBITION AGAINST COLLECTIVE ANTICOMPETITIVE PRACTICES

a. Structure of the E.E.C. Treaty, Article 85

The E.E.C. Treaty, Article 85,⁶²⁵ following the example of the Coal-Steel Community Treaty, Article 65,⁶²⁶ contains a specific pro-

⁶²¹ E.E.C. Treaty art. 90(1).

⁶²² E.E.C. Treaty art. 85(1)(d).

⁶²³ E.E.C. Treaty art. 86(c).

⁶²⁴ See Reuter *op. cit. supra* note 580, at 12.

⁶²⁵ For the text, see *supra* part I, Sec. A, 1.

⁶²⁶ For the text, see *supra* part III, Sec B, a(1).

hibition against collective anticompetitive conduct by enterprises. A comparison between the two Articles shows unmistakably that the former is an extrapolation of the latter. Both Articles proscribe collective anticompetitive action in the nature of "agreements between enterprises, decisions by associations of enterprises and concerted practices"; both Articles designate the anticompetitive character of the prohibited conduct with the terms "hinder, restrain or adulterate . . . competition"; both Articles are couched in the form of a general clause followed by a list of specific categories of anticompetitive practices; both Articles, finally, envisage exemptions from the prohibition. But there are numerous significant differences in the two provisions relating to (1) the formulation of the general clause, (2) the classes of anticompetitive practices specifically enumerated, and (3) exemptions.

(1) *Formulation of the general clause of the prohibition.*

While the Coal-Steel Community Treaty, Article 65(1), encompasses all enterprise actions of the specified collective nature which "tend," directly or indirectly, to be anticompetitive within the Common Market, the general clause of E.E.C. Treaty, Article 85(1), applies to the defined collective enterprise actions only if they (a) are capable of affecting [adversely]⁶²⁷ the commerce among the Member States and (b) have the designated anticompetitive character within the Common Market "as their object or effect." In other words, the prohibition of Article 85(1) covers only such collective conduct of anticompetitive purpose or effect which is not purely intra-national but adversely affects commerce between Member States within the Common Market.⁶²⁸ It is perhaps worth noting in passing that the E.E.C. Treaty does not refer to "normal competition" as its predecessor does but merely to "competition" pure and simple.

(2) *Specified categories of anticompetitive conduct.* The E.E.C. Treaty, as compared with the Coal-Steel Community Treaty, expands the number and, in part, the scope of the categories of anti-

⁶²⁷ The addition of the adverb "adversely" is based on the German, Italian and Dutch version of the controlling texts. It is not required by the French version. However, the Commission's Directorate General for Competition and the government experts on restrictive practices seem to endorse the reading given in the text. Whether a given practice is capable of affecting commerce among the Member States must be determined on the basis of the indications available at the time that decision is made, E.E.C. Commission, THIRD GENERAL REPORT No. 140 (1960).

⁶²⁸ According to the Commission and the government experts, the term "common market" refers to it as a geographical unit, 1959 BULLETIN OF THE EUROPEAN ECONOMIC COMMUNITY, 38 (No. 2, May 1959); E.E.C. Commission THIRD GENERAL REPORT No. 140 (1960).

competitive practices specifically listed following the general prohibitory clause. The Coal-Steel Community Treaty lists only three special classes of such practices, price-fixing, limitations of production, technological development, or investments, and division of markets or sources of supply. The E.E.C. Treaty adds two further categories: (a) discriminations against customers in comparable positions, with resulting competitive disadvantages for them, and (b) the insistence on tying clauses not warranted by the nature of the tied-in matter or commercial custom, apparently following the example of the analogous provisions of a French ordinance.⁶²⁹

Under the E.E.C. Treaty, as under the Coal-Steel Community Treaty, there exists the problem as to the correct relationship between the elements of the general prohibitory clause and the definitions of specified anticompetitive practices in the catalogue following it. It seems to be beyond question that the enumerated practices are proscribed only if they are capable of affecting adversely the commerce between Member States.^{629a} It is, however, an open question whether, in addition, it must be shown that they have an anticompetitive character as their object or effect, or whether such nature is conclusively presumed for the classes singled out by the Treaty. The answer must await further clarification in practice.^{629b}

(3) *Possibility of exemptions from the prohibition.* Following the example of Coal-Steel Community Treaty, Article 65(2), and of the French cartel decrees of 1953-1958, the E.E.C. Treaty provides for exemptions from the sweeping prohibition of Article 85(1).⁶³⁰ These exceptions cover those agreements between enterprises, decisions of associations of enterprises, and concerted practices of enterprises, which the framers of the Treaty deemed to be capable of an over-all salutary effect. Accordingly, authorization of an exemption is predicated on the fulfillment of four cumulative conditions, namely, that the agreements, decisions or practices in question

(a) contribute to the improvement of the production or distribution of products, or to the promotion of technical or economic progress;

⁶²⁹ Ordinance No. 45-1483, art. 37(a) and (c) as amended. See *supra* note 188 and text at that note; cf. also Fabre, *Les Pratiques commerciales restrictives et le Traité de Marché Commun*, 1958 REVUE DU MARCHÉ COMMUN, 260 (No. 5).

^{629a} Accord, E.E.C. Commission, THIRD GENERAL REPORT No. 140 (1960).

^{629b} See *infra*, text at note 654.

⁶³⁰ E.E.C. Treaty art. 85(3).

(b) leave an equitable share of the resulting gain to the consumers;

(c) refrain from subjecting the enterprises involved to restraints which are not indispensable for the attainment of those goals;

(d) do not give those enterprises the power of eliminating competition for a substantial portion of the products in question.

It would seem, therefore, that the E.E.C. Treaty employs greater latitude in the matter of exemptions from the prohibition against collective anticompetitive practices than the Coal-Steel Community Treaty which accords such privilege only to a few designated categories of cartel agreements.

Moreover, the former Treaty permits greater flexibility in the administration of the exemptions than the latter, which requires the High Authority to grant approval to cartel agreements whenever the delineated standards are met and confines the High Authority to a case-by-case procedure. According to E.E.C. Treaty, Articles 85(3) and 87(2)(b), the dispensation seems to be discretionary, and its availability may be determined in detail by general regulations, including regulations which accord blanket exemption in advance to specified categories of restrictive agreements or practices deemed to meet the requisite standards.

Until the issuance of these general regulations, the appropriate authorities of the Member States are empowered to decide on the applicability of the exemptions,⁶³¹ apparently by following a case-by-case approach.⁶³² Finally, it should be noted that the prohibitions of Article 85(1) apply to agricultural products only to the extent that will be determined by the Council.⁶³³

b. *The Problem of Immediate Applicability*

E.E.C. Treaty, Article 87, requires the Council to issue regulations for the purpose of implementing the prohibitions and dispensations provided for in Article 85. In particular such regulations should pertain to:

⁶³¹ E.E.C. Treaty art. 88.

⁶³² The German Cartel Office has employed the power flowing from art. 88 in connection with art. 85(3) and has granted a temporary dispensation for restrictive patent licensing agreements. Bundeskartellamt, *Bericht über seine Tätigkeit in Jahre 1959*, Deutscher Bundestag, 3. Wahlperiode, Drucksache 1795, 55 (1960). For one of these decisions see Federal Cartel Office, Adjudication Division, Order of Feb. 19, 1959 (thread-cutting machinery), 9 WuW 259-305 (1959).

⁶³³ E.E.C. Treaty art. 42.

- 1) measures of constraint appropriate to assure the observance of the prohibitions;
- 2) the details governing the application of the provision for possible exemption;
- 3) the scope of applicability of Article 85 with respect to particular branches of the economy;
- 4) the delineation of the relative functions of the Court and the Commission in the application of these regulations;
- 5) the determination of the relation between the national legal systems and the rules governing competition contained in either the Treaty or the implementing regulations.

In view of the importance and the scope of the regulations so envisaged a veritable literary battle has been fought as to whether or not the prohibitions and possible dispensations provided in Article 85 constitute *directly* and *immediately* applicable rules of law, even prior to the issuance of the regulation under Article 87.⁶³⁴

⁶³⁴ Of the copious literature, mention may be made of the following: Brijnen & Wertheimer, *De Interpretatie van de Kartelbepalingen in het EWG-Verdrag* (with postscript by Verloren van Themaat), 5 SOCIAAL-ECONOMISCHE WETGEVING 253 (1957); Coing-Kronstein-Schlochauer, *Das Verhältnis des deutschen Kartellrechts zu den kartellrechtlichen Vorschriften des EWG Vertrags*, 7 SCHRIFTEN DES INST. F. AUSL. & INTERN. WIRTSCHAFTSRECHT (1958); Del Marmol, *Marché commun et ententes internationales*, [1957] FABRIMÉTAL 492; PLAISANT AND LASSIER, *ENTENTES ET MARCHÉ COMMUN* (Comité d'Action et d'Expansion Economique, 1960); Deringer, *Zwei Jahre europäische Kartellpolitik*, 3 EUROPÄISCHE WIRTSCHAFT 43-47, 66-68 (1960); Fabre, *Les Pratiques Commerciales Restrictives et le Traité de Marché Commun*, 1 REVUE DU MARCHÉ COMMUN 260 (1958); van Geldern, *Le problème de l'applicabilité directe des règles de concurrence dans la CEE*, 5 NED. TIJDSCHR. VOOR INTERNATIONAAL R. 366 (1958); Günther, *Die Regelung des Wettbewerbs im Vertrag zur Gründung der Europäischen Wirtschaftsgemeinschaft*, 7 WUW 275 (1957); Koch, *Das Verhältnis der Kartellvorschriften des EWG Vertrages zum Ges. geg. Wettbewerbsbeschränkungen*, 14 BETRIEBS-BERATER 241 (1959); Obernolte, *Die Wettbewerbsbedingungen im Gemeinsamen Markt*, 3 EUROPÄISCHE WIRTSCHAFT 93-95, 162-164, 183-184 (1960); Peters, *Die Wettbewerbsbestimmungen für den Gemeinsamen Markt*, 1 EUROPÄISCHE WIRTSCHAFTSGEMEINSCHAFT 126, 146 (1958); Reuter, *Ententes et cartels (Apropos de l'application des art. 85 et suiv.)*, 1959 REVUE DU MARCHÉ COMMUN 46 (No. 10); Schumacher, *La politique de la CEE en matière d'ententes*, 1959 REVUE DU MARCHÉ COMMUN 207 (No. 14); Schumacher, *Enthalten die Artt. 85 und 86 des EWG Vertrages bereits in den Mitgliedsstaaten geltende Rechtsnormen?* 8 WUW 779 (1958); Spengler, *Die Vertragsbestimmungen über die Wettbewerbsregeln im Gemeinsamen Markt*, 21 DER BETRIEB 75 (1959); Spengler, *Abgrenzung zwischen GWG und EWG-Vertrag*, in Müller-Henneberg & Schwartz, *GESETZ GEGEN WETTBEWERBSBESCHRÄNKUNGEN*, Anh. zu § 101, No. 3 (1958) and in 8 WUW 73, 461 (1958); SPENGLER, *DIE WETTBEWERBSREGELN DER EUROPÄISCHEN WIRTSCHAFTSGEMEINSCHAFT*, BUNDESVERBAND DER DEUTSCHEN INDUSTRIE, (Drucks. No. 46) (1957); Steindorff, *Das Verbot von Wettbewerbsbeschränkungen in der Anfangszeit der EWG*, 13 BETRIEBS-BERATER 89 (1958); Strickrodt, *Geltungskraft und Geltungsumfang der Wettbewerbsregeln im Vertrag über den Gemeinsamen Markt*, DER BETRIEB, 3 (Beilage Nr. 9/57); Snetens, *De mededingingsregeling voor ondernemingen in het Verdrag der Europese Economische Gemeenschap*, 23 RECHTSKUNDIG WEEKBLAD 954 (1960); Verloren van Themaat, *De Kartelpolitiek in der Europese Economische Gemeenschap*, 5 SOCIAAL-ECON. WETGEVING

There is little point in reviewing the arguments *pro* and *con* or in discussing the many nuances of the divergent views advanced, but a brief survey of the practical developments and of the present status of the issue should be useful.

The controversy over the legal status of the rules governing competition of enterprises in Article 85 and the following articles precipitated lengthy debates in the Dutch Parliament on the occasion of the ratification of the E.E.C. Treaty.⁶³⁵ The government took the position that the interrelation of the various provisions in these articles warranted the conclusion that the rule of Article 85(2), which declared agreements or decisions prohibited by that article to be null and void, did not become operative until the enactment of the regulations envisaged by Article 87. This position was enshrined in a bill purporting to execute Article 88 of the Treaty. The bill was enacted into law on December 5, 1957.⁶³⁶ It provides that arrangements regulating competition, as mentioned in E.E.C. Treaty, Article 88, shall be unexceptionable and no misuse of a dominant position in the Common Market, as mentioned in said Article, shall be deemed to be made so long as, and to the extent that, the appropriate Dutch authorities have not interceded by virtue of the Cartel Ordinance of 1941 or the Economic Competition Act of 1956. The applicability of the Act was limited to a period beginning with the entry into force of the E.E.C. Treaty and ending with the issuance of the regulations under Article 87.

The constitutionality of this legislation was drawn into issue in 1958 in a much-noted litigation pending in the District Court of Zutphen.⁶³⁷ Plaintiff and defendant had entered into an agreement dividing between them the Belgian and Dutch markets for a particular product. Upon the entry into force of the E.E.C. Treaty, the defendant, a Dutch corporation, claimed that the agreement had become null and void and refused further compliance. Plaintiff sued for specific performance. The Court granted the relief prayed for.

224 (1957); Verloren van Themaat, *Fünf Grundsätze der europäischen Wettbewerbspolitik*, 2 *EUROPÄISCHE WIRTSCHAFT* 335 (1960); Weebers, *Kartelcontrôle op de Europese Gemeenschaplijke Markt*, 35 *DE NAAMLooZE VENNOOTSCHAP* 86 (1957); Thiesing in 1 *GROEBEN-BOECKH, KOMMENTAR ZUM EWG-VERTRAG*, comments to art. 85 (1958); *WOHLFAHRT-EVERLING-GLAESNER-SPRUNG, KOMMENTAR ZUM EWG-VERTRAG* comments to art. 85 (1960).

⁶³⁵ Proceedings of the Second Chamber, Oct. 1-4, 1957; Proceedings of the First Chamber, Dec. 3 and 4, 1957.

⁶³⁶ Staatsbl. (No. 528, 1957).

⁶³⁷ *S.A. Tuberies Louis Julien v. N.V. Van Katwijk's Papier en carton verw. Ind.*, 1958 *NED. JURISPR.* 984, noted by Schumacher, 8 *WuW* 779 (1958), Steindorff, 13 *BETRIEBS-BERATER* 931 (1958).

It held that the act of December 5, 1957, supported the complaint and that the act was not invalid because of inconsistency with the Treaty since Article 85(2) could not be considered to be directly applicable prior to the issuance of the regulations under Article 87.⁶³⁸

In Germany the problem of the immediate and direct applicability of Article 85(1) and (2) was raised in two suits to enjoin violations of retail price maintenance systems brought by manufacturers against retailers.⁶³⁹ In both cases, however, the courts saw no necessity for passing on the issue since they found that the price-fixing schemes in question did not adversely affect commerce between the Member States. The German Cartel Office, however, has held that Article 85(1) and (3) is immediately applicable and must be considered in applications to the Cartel Office for approval of patent licenses with restrictive clauses, submitted under Section 20(3) of the German Restraints of Competition Act.⁶⁴⁰

The position of the German Cartel Office was endorsed by the government experts on cartels (who studied the principal problems arising from Articles 85-90 in a series of conferences convened by the staff of the Commission), as well as by the latter body itself and by the Parliamentary Assembly.⁶⁴¹ According to the conclusions

⁶³⁸ The judgment was appealed to the Court of Appeal at Arnhem, 6 NED. TIJDSCHR. V. INTERN. RECHT 408.

⁶³⁹ Court of Appeals of Düsseldorf, Order of Oct. 21, 1958, 2 W 47/58, 4 WETTBEWERB IN RECHT UND PRAXIS 382 (1958); 13 BETRIEBS-BERATER 1110 (1958); District Court of Frankfurt, Order of Feb. 13, 1959, 14 BETRIEBS-BERATER 210 at 213 (1959).

⁶⁴⁰ *Bericht des Bundeskartellamtes über seine Tätigkeit im Jahre 1959*, Deutscher Bundestag, 3. Wahlperiode, Drucksache 1795, at 55 (1960). See Thread-cutting machinery case, Cartel Office, Adjudication Division, Order of Feb. 19, 1959, 9 WUW 305 (1959). In that and the other cases dispensation was granted under E.E.C. Treaty 85(3) in conjunction with art. 88.

⁶⁴¹ As of May 1, 1960 seven conferences of the national cartel experts had been held. The first of them met on Nov. 18-19, 1958 and was followed by others taking place on Jan. 15-16, 1959; April 14-15, 1959; June 29-30, 1959; October 8-9, 1959; December 15-16, 1959; March 16-17, 1960. These conferences have deliberated consecutively: upon the effect of articles 85 and 86; the functions of the national authorities and the Commission under articles 88 and 89 in the present enforcement of the rules on competition; the cases falling within the categories specifically listed in art. 85(1); the characteristics of a dominant position; the impact of existing or proposed national procedures on the procedures to be followed on the Community level; the effect of art. 90 on the position of public enterprises and enterprises operating under a public franchise; the procurement of requisite data. For the conclusions reached see Communauté Economique Européenne, Commission, PREMIER RAPPORT GÉNÉRAL, III, 59 ff. (1958); DEUXIÈME RAPPORT GÉNÉRAL, 85 (1959); THIRD GENERAL REPORT, III, 32-38 (1960); BULLETIN OF EUROPEAN ECONOMIC COMMUNITY, Engl. ed. 26 (No. 1-58), 37 (No. 2-59), 47 (No. 3-59); French ed. 24 (No. 1-59), 40 (No. 1-60), 38 (No. 3-60), 39 (No. 4-60); Germ. ed. 45 (No. 4-59), 49 (No. 5-59). For résumés of the conclusions of the first three conferences of the national experts see 9 WUW 445 (1959); for information on the succeeding four conferences see EUROPE, EURATOM & MARCHÉ

reached by these authorities the wording and the interrelation of the various pertinent articles have the result that

- 1) the prohibitions of Article 85(1) and the provision for dispensations of Article 85(3) are immediately and directly operative legal rules;
- 2) the national authorities, under Article 88,⁶⁴² and the Commission, under Article 89,⁶⁴³ are jointly charged with their current application, the principal responsibility for this task resting with the national authorities;
- 3) the Member States are obligated to designate the proper agencies for, and to regulate the applicable procedure in, the performance of the functions entrusted to the national authorities by Article 88.

As Italy,⁶⁴⁴ Belgium, until May 27, 1960, and Luxembourg had no legislation sufficient to constitute a compliance with their duty in that respect, the Commission addressed a letter to these three governments inviting them to take the necessary steps.⁶⁴⁵

The Commission has taken great pains to point out that its position has no necessary bearing on, and leaves still unsolved, the question of whether the illegality and invalidity of the prohibited practices, as established by Article 85(2), can be invoked prior to

COMMUN, DAILY BULLETIN No. 446 (June 27, 1959); No. 528 (Oct. 16, 1959); No. 577 (Dec. 14, 1959); No. 624 (Mar. 15, 1960).

⁶⁴² Art. 88 provides: "Until the time when the regulations issued under Article 87 go into effect, the authorities of the Member States pass on the permissibility of collective practices and on the misuse of a dominant position in the Common Market in conformity with the law of their countries and the provisions of Article 85, in particular paragraph 3, and of Article 86."

⁶⁴³ Art. 89 provides: "(1) Without prejudice to Article 88, the Commission, from the assumption of its functions, shall watch over the execution of the principles laid down in Articles 85 and 86. Either upon request by a Member State or upon its own initiative, and in conjunction with the appropriate authorities of the Member States which are bound to render official assistance, it shall investigate the cases in which infractions of these principles are suspected. If an infraction be found it proposes the measures appropriate to terminate the same. (2) If the infraction does not cease the Commission shall find the existence of such infraction in a reasoned opinion. It may publish that decision and authorize the Member States to take the measures necessary for remedying the situation, specifying their terms and details."

⁶⁴⁴ The Italian legislature, when authorizing ratification of the E.E.C. Treaty, empowered the government to issue the decrees "necessary . . . to effectuate the measures provided by article . . . 89 . . . , [and] to accord, consistent with the combined content of articles 85 and 88 of the E.E.C. Treaty, the dispensations envisaged by art. 85(3) of said Treaty." Law No. 1203 of Oct. 14, 1957, *Gazzetta Ufficiale* No. 317 of Dec. 23, 1957 (supp. ord. 2).

⁶⁴⁵ BULLETIN DE LA COMMUNAUTÉ ÉCONOMIQUE EUROPÉENNE 27 (No. 1-58). In the interest of uniformity the Commission has expressed preference for the designation of administrative agencies as appropriate authorities for the performance of the functions under art. 88. C.E.E., Commission, DEUXIÈME RAPPORT GÉNÉRAL 88 (1959).

an intervention by the appropriate authorities under Articles 88 and 89.⁶⁴⁶ In other words, the issue which was actually before the District Court in Zutphen is still unresolved and requires ultimate clarification by the Court of Justice.⁶⁴⁷

c. *Scope of the Prohibitions*

As might be expected, the broad formulae of the prohibitions of Article 85(1) have shown, and are bound to show in the future, a marked proclivity to spawn delicate problems of interpretation respecting their scope. The Council sensibly has hesitated to issue the supplementary regulations envisaged by Article 87. As far as the broader contours are concerned, however, a prevailing trend of opinion is in the state of crystallization with a reasonable prospect of governing the practice.

Generally speaking, the conduct of enterprises in order to fall under the proscription of Article 85(1) must possess three characteristics. It must:

- 1) be capable of adversely affecting the commerce between member states;
- 2) be of collective nature;
- 3) possess anticompetitive characteristics within the meaning of the governing provisions.

(1) *Capability of adversely affecting the commerce between Member States.* It has been observed before that only conduct which is capable of adversely affecting the commerce between Member States falls under the prohibition of the Treaty. Practices which remain wholly intra-national in their effect remain outside the regulation of Article 85.⁶⁴⁸ Conversely, restrictive agreements which cover only the foreign commerce of a Member State without producing anticompetitive repercussions in the domestic market, and which for that reason may be permissible under national cartel laws, are nevertheless prohibited by the Treaty if they are capable of affecting the

⁶⁴⁶ C.E.E., Commission, DEUXIÈME RAPPORT GÉNÉRAL 89 (1959).

⁶⁴⁷ E.E.C. Treaty art. 177 requires that issues pertaining to the interpretation of the Treaty that are necessary for a decision by a national court of last resort must be certified for determination to the European Court of Justice.

⁶⁴⁸ Thus the recent short-lived German Coal and Fuel Oil cartel, formed in order to relieve the technological depression of the coal industry, was approved by the German Minister of Economic Affairs on Feb. 17, 1959, by virtue of his emergency powers under the German Restraints of Competition Act, only after an express finding, pursuant to E.E.C. Treaty art. 88, to the effect that the cartel did not adversely affect the commerce between Member States, *i.e.*, did not have anticompetitive effects outside Germany. (See the text of the decree, 9 WuW 385.) Cf. also similar findings by the Düsseldorf Court of Appeal and the Frankfurt District Court in the two opinions, *supra* note 639.

commerce of other nations. Export cartels, consequently, are no longer immune unless the effect of their operations does not spill over into the area of the Common Market.⁶⁴⁹

(2) *Types of collective action reached by the prohibitions.* Although the wording of the prohibitions of Article 85(1) is not entirely free from ambiguity, there seems to be a widespread acceptance, both in doctrine⁶⁵⁰ and in practice,⁶⁵¹ of the interpretation which does not restrict their application to *horizontal* arrangements but includes those of a purely *vertical* character. As has been pointed out before, a similar construction prevails for the analogous provision of the Coal-Steel Community Treaty.⁶⁵² An opposite conclusion would outlaw vertical restrictive agreements only if they are concluded by an enterprise possessing dominant market power.

As a result of the prevalent view, price maintenance schemes, tying agreements, exclusive dealing and requirement contracts, etc., may fall under the sweep of Article 85(1). The prohibition applies, however, only if such agreements are of an anticompetitive character within the meaning of Article 85 and if they are capable of adversely affecting the commerce between Member States. The latter element usually will be absent if such agreements, as frequently is the case, are confined to the national market.⁶⁵³

(3) *Anticompetitive character within the meaning of Article 85(1).* Finally, collective practices are prohibited only if they have anticompetitive character as defined in Article 85(1). The general clause considers practices as anticompetitive if they have "the object or effect of hindering, restraining or adulterating competition" within the Common Market. Ordinarily, therefore, a finding of the presence or absence of this element will depend on an eco-

⁶⁴⁹ C.E.E., Commission, PREMIER RAPPORT GÉNÉRAL, III, 59 ff. (1958); *Bericht des Bundeskartellamtes über seine Tätigkeit im Jahre 1959*, *op. cit. supra* note 640, at 55. See also Verloren van Themaat, *De Kartelpolitiek in de Europese Economische Gemeenschap*, 5 SOCIAAL ECONOMISCHE WETGEVING 224, at 227 (1957).

⁶⁵⁰ Verloren van Themaat, *op. cit. supra* note 649, at 227 (1957); Günther, *Die Regelung des Wettbewerbs im Vertrag zur Gründung der Europ. Wirtschaftsgemeinschaft*, 7 WUW 275, at 280 (1957); Schwartz, *E.W.G.-Vertrag und vertikale Bindungen*, DER MARKENARTIKEL 317 (1959); but see Guglielmetti, *Les exclusivités de vente*, in LA LIBRE CONCURRENCE DANS LES PAYS DU MARCHÉ COMMUN (Journées d'études de Caen, May 8-10, 1959), 1959 REVUE DU MARCHÉ COMMUN, 38, at 41 (Suppl. to No. 16).

⁶⁵¹ See the decisions by the two German courts, *supra* note 639, and the decisions by the German Cartel Office in the thread-cutting machinery case and their licensing agreements, *supra* notes 632 and 640.

⁶⁵² See *supra* part III, text at notes 532 and 533.

⁶⁵³ See the discussion of this point by Günther, *Marketing und Preisbindung der zweiten Hand*, 9 WUW 843, at 847, 848 (1959).

conomic analysis of the pertinent market conditions. Whether, however, such procedure is needed even in those classes of cases which are specifically enumerated is subject to considerable doubt. The government experts on cartels apparently have not reached a definite agreement on that point.⁶⁵⁴

Particular doubts have been voiced about the status of *exclusive dealer franchises*, whether territorially circumscribed or not, and of *requirement contracts*.⁶⁵⁵ It is not clear whether or not such agreements or certain types of them are included within the special category of Article 85(1)(c), covering the division of markets or sources of supply. If not, such arrangements would be considered as anticompetitive only on the basis of their object or their likely effect on the market. At any rate, frequently they should constitute proper instances for a dispensation under Article 85(3) and Article 88.

2. ENFORCEMENTS: SANCTIONS AT PUBLIC AND PRIVATE LAW

a. *Sanctions at Public Law*

The enforcement of the prohibitions of Article 85 by public authorities has already been discussed in various respects. Basically the Treaty of Rome adopts a system of decentralization, at least until the issuance of regulations under Article 87. It differs sharply in this respect from the regime of the Coal-Steel Community Treaty which vests the exclusive jurisdiction to determine the existence of a violation of its anticartel provisions in the High Authority.⁶⁵⁶ The national authorities, whether administrative agencies or courts imposing penalties, employ their own methods of procedure and sanctions, so far as made applicable, but they determine the legality or illegality of the conduct in issue by reference to the prohibitions and dispensations of Article 85(1) and (3).

The form and scope of judicial review are likewise determined by the national legal systems,⁶⁵⁷ with the qualification, however, that relevant questions as to the interpretation of the Treaty must be resolved by the Court of Justice prior to a decision of a national court of last resort.⁶⁵⁸

⁶⁵⁴ See the report on the 5th meeting of the government cartel experts, BULLETIN OF THE EUROPEAN ECONOMIC COMMUNITY, Germ. ed. 46 (No. 4-59), 49 (No. 5-59).

⁶⁵⁵ See the report by Guglielmetti, *Les exclusivités de vente*, at the Caen meeting, and the discussion thereof, *op. cit. supra* note 650, at 41 and 54; see also Schwartz, *op. cit. supra* note 650.

⁶⁵⁶ E.C.S.C. Treaty art. 65(4), para. 2.

⁶⁵⁷ Nebolsine, *The 'Right of Defense' in the Control of Restrictive Practices under the European Community Treaties*, 8 AM. J. COMP. L. 433 at 444 (1959).

⁶⁵⁸ E.E.C. Treaty art. 177.

b. *Private Law Consequences of Violations*

Unquestionably the most perplexing problems in the application of the Treaty rules on competition for enterprises concern the private law consequences of infractions. Generally speaking, such consequences may be of two principal types:

- 1) unenforceability (invalidity) of a proscribed transaction;
- 2) civil liability in tort for the proscribed practice (whether or not constituting a transaction).

(1) *Invalidity of anticompetitive agreements.* Article 85(2) declares flatly: "Agreements and decisions which are prohibited by this article are absolutely void." Despite the categorical nature of this clause, its meaning and effect have been the object of violent arguments, as was pointed out in the previous section.⁶⁵⁹

The heart of the conflict as it remains⁶⁶⁰ concerns the question of whether this section applies unqualifiedly under the regime of Articles 88 and 89, *i.e.*, prior to the issuance of regulations under Article 87, or whether during this period agreements remain enforceable as long as the appropriate authorities have not determined their illegality on the combined basis of Article 85(1) and (3).⁶⁶¹ If unenforceability can be predicated only on an intervention by the appropriate authorities, the further question arises as to whether a finding of a violation by these authorities depends exclusively on an extremely delicate interpretation of the Treaty. No conclusive solution can be suggested until the Court of Justice has spoken.

(2) *Tort liability for participation in anticompetitive practices.* Even greater mystery surrounds the question as to the possible tort liability of enterprises which actively participate in collective restrictive practices. Like Article 65 of the Coal-Steel Community Treaty, Article 85 and the following Articles of the E.E.C. Treaty contain no direct rules on the civil responsibility attendant upon infractions. Hence the answer must depend on the complex and delicate issue of how the Treaty discipline governing the competition of enterprises is interlaced with the general fabric of national law.

Certainly the indicated enigma will plague the profession until the issuance of regulations under Article 87. Whether that Article empowers the Council to determine the matter on a supranational level is difficult to predict. Article 87(2) (e) envisages the adoption

⁶⁵⁹ See *supra* text at note 634.

⁶⁶⁰ See *supra* text at note 646.

⁶⁶¹ See the careful analysis of the various positions and arguments by Schumacher, *La politique de la CEE en matière d'ententes*, 1959 REVUE DU MARCHÉ COMMUN 207.

of rules "for the purpose of defining the relation between the national legal systems on the one hand and the provisions contained in, or enacted pursuant to, the article." This may imply that the Council could specify whether or not violations constitute a tort under national laws. If such an interpretation were rejected, the Treaty provisions relative to the harmonization of the national legislation⁶⁶² might be the proper avenue for reaching uniformity.

Prior to such action, however, the situation is quite perplexing. If the view is followed that the transitional regime of Articles 88 and 89 requires intervention by the public authorities before the prohibitions of Article 85(1) can be invoked by private parties, no tort liability for violation under national laws could ensue, except after disregard of such repressive action. Conversely, if the position is taken that the *invalidity* of collective anticompetitive transactions can be invoked by private parties directly and immediately, it would be consistent to conclude that the same rule applies to the assertion of *illegality*. Whether, however, such illegal conduct actually amounts to a tort which entitles injured private parties to redress is a further question which still would require additional analysis of both the nature of the Treaty provisions and the basis of tort liability under national laws.

In Germany, for example, as has been pointed out before,⁶⁶³ tort liability in such cases conceivably may be rested on four statutory grounds (Civil Code, Sections 823 I, 823 II, 826, and Law Against Unfair Competition, Section 1), among which the second is the most important one. It predicates liability in damages upon any culpable violation of a "law, enacted for the purpose of protecting a third party." The question thus reduces itself to the issue of whether Article 85 is such a law or whether it is merely a regulation enacted in the interest of guaranteeing a sound market policy. Since the German Supreme Court has differentiated in that way even with respect to various sections of its own national Restraint of Competition Act⁶⁶⁴ no answer to the problem can safely be predicted at this time.

⁶⁶² E.E.C. Treaty arts. 100-102. For a good discussion see Bärmann, *Die Europäischen Gemeinschaften und die Rechtsangleichung*, 14 JURISTENZEITUNG 553 (1959).

⁶⁶³ See *supra* part II sec. A, 2b and part III, sec. B, 1b.

⁶⁶⁴ Thus the German Supreme Court has based tort liability vis-à-vis competitors on the establishment of unregistered resale price maintenance schemes (Eau de Cologne case, decision of Oct. 8, 1958, 13 BETRIEBS-BERATER 1075, at 1079 (1958)) and on discriminatory exclusion from a trade association (decision of Feb. 25, 1959, 14 BETRIEBS-BERATER 356, 357 (1959)). Conversely, it has denied the quality of "a law enacted for the protection of a third party" to the provisions of the Restraint of Competition Law governing requirement contracts (decision of Oct. 20, 1959, 14

It must clearly be understood, however, that a position according to which a violation of the provisions of Article 85 is not a tort *in and by itself* by no means compels the conclusion that all such conduct is immune from civil responsibility. Rather, liability will be entailed if such practice constitutes a private wrong by the separate standards of national law.

C. PROTECTION AGAINST MISUSE OF DOMINANT MARKET POWER

I. SCOPE AND EFFECT OF ARTICLE 86

a. *Scope of Prohibition*

Like the Coal-Steel Community Treaty (in its Article 66(7)) the E.E.C. Treaty (in Article 86) includes a special prohibition against the abusive exploitation of a dominant position⁶⁶⁵ within the Common Market or a significant part thereof by one or several enterprises, with, however, the important qualification that this injunction applies only to the extent that such misuse is "capable of adversely affecting the commerce among the Member States."

Again, as in Article 85(1), the general clause of the prohibition is followed by a catalogue of four types of practices in which such misuse may consist in particular. These practices are:

- 1) the direct or indirect imposition of inequitable purchase or sales prices or other business terms;
- 2) the limitation of production, outlets, or technical development to the prejudice of the consumers;
- 3) the application, vis-à-vis other parties in business deals, of unequal terms for equivalent goods or services, thereby inflicting upon them competitive disadvantages;
- 4) predicating the conclusion of contracts upon the condition that the other parties accept supplementary goods or services which neither by their nature nor business usage are related to the object of these contracts.

BETRIEBS-BERATER 1229) and to the rules against price discrimination in the E.C.S.C. Treaty (decision of April 14, 1959, 30 BGHZ 74).

⁶⁶⁵ The Commission and the government experts on cartels, at their 5th Conference on restrictive practices of enterprises, studied the criteria and data by which the existence of a dominant position ought to be determined. It was decided to embark on a statistical inquiry covering various economic sectors in which special conditions exist, such as the public utilities field, banking and insurance; see the reports in BULLETIN OF THE EUROPEAN ECONOMIC COMMUNITY, Germ. ed. 46 (No. 4-59), 49 (No. 5-59); EUROPE, DAILY BULLETIN, EURATOM & MARCHÉ COMMUN No. 528 (Oct. 16, 1959).

As can be seen, therefore, Article 86 in its structure is quite analogous to Article 85(1). Accordingly, the same general problems as to the interrelation of the various clauses arise.⁶⁶⁶ There is, however, one important difference. Article 86 does not provide for dispensation from the prohibition. Nevertheless, it should be noted that Article 87 does authorize the issuance of regulations "for the purpose of defining the scope of applicability of Article 86 for particular branches of the economy."⁶⁶⁷

b. *Practical Significance*

Article 86 can hardly be expected to be of paramount practical significance especially if, as commonly assumed, Article 85(1) is to be construed to apply to purely vertical restrictive agreements falling within the categories specifically defined in that article. In such cases Articles 85 and 86 will be largely overlapping.

Nonetheless, it would be a grave mistake to conclude that there cannot or will not be important types of situations in which Article 86, particularly its general clause and its first two classes of specially proscribed practices, will furnish the only palliative against anti-competitive actions by enterprises with dominant market power. This will be the case, in the first place, in all instances where such enterprises create artificial scarcities or in other ways misuse their economic power, without acting by means of agreements or in concert with other enterprises. In the second place, the special classes defined in Article 85(1)(a) and Article 86(a) resemble one another only in a most superficial fashion and actually cover quite different matters. To be sure, both may relate to purely vertical

⁶⁶⁶ See the conclusions to that effect reached at the 5th Conference of government experts on cartels, BULLETIN OF THE EUROPEAN ECONOMIC COMMUNITY, Germ. ed. 49 (No. 5-59).

⁶⁶⁷ A possible limitation of the applicability of art. 86 flows from the special provision of art. 90(2). Art. 90(1) prescribes in general terms that the Member States shall not take or retain measures in conflict with this Treaty and, in particular, with arts. 7 and 85 to 95 in respect to public enterprises or enterprises to which they have accorded special or exclusive rights. Art. 90(2), however, adds the following qualification: "Enterprises charged with the management of services of general public interest or possessing the character of a fiscal monopoly are subject to the provisions of this Treaty, especially the rules of competition to the extent that the application of these provisions does not prevent, legally or factually, the performance of the tasks conferred upon them. The development of trade must not be impaired in a degree which contravenes the interest of the Community." The interpretation of Art. 90(1) and (2) has been the subject of study by the Commission's Directorate General for Competition and the government experts on restrictive practices and of discussions with the Member States, E.E.C. Commission, THIRD GENERAL REPORT III, 37 (1960); BULLETIN OF THE EUROPEAN ECONOMIC COMMUNITY, Germ. ed. 50 (No. 5-59); Engl. ed. 38 (No. 4-60).

stipulations relating to prices and other business terms. But Article 85(1)(a) concerns the fixing of prices or business terms which the other party to the agreement must observe in its dealings with *third* persons, while Article 86(a) applies to bargains which the enterprise with dominant market power is able to exact from its suppliers or customers for its own benefit.

2. SANCTIONS AGAINST, AND PRIVATE LAW CONSEQUENCES OF, MISUSE OF DOMINANT MARKET POWER

Little needs to be added with reference to the sanctions against, or the private law consequences of, misuses of dominant market power. In every important respect the situation is parallel to that existing relative to the collective restraints on competition.

Until enactment of the regulations under Article 87 the national authorities and the Commission are jointly responsible for the suppression of misuses of dominant market power.⁶⁶⁸ Although Article 86 declares flatly that the misuse defined thereby is prohibited, the questions of whether, under the regime of Articles 88 and 89, agreements constituting such misuse are unenforceable without previous intervention by the authorities and whether practices falling under that article render the perpetrator liable in tort under national laws will require answers depending on the same considerations and reaching the same results as were discussed in the previous part of this chapter.

D. PROTECTION AGAINST DUMPING

The treaty provisions against anticompetitive practices and measures, especially as contained in Articles 85–90, are supplemented by Article 91 which establishes a separate regime for the suppression of dumping, applicable during the transitional period. According to Article 91(1), if the Commission, upon request by a Member State or an interested party, finds that a private enterprise or public entity engages in dumping practices within the Common Market, it shall direct a recommendation to cease and desist to the responsible person or persons. If the parties persist in the dumping prac-

⁶⁶⁸ The Commission and the national authorities have worked out a consultation procedure which must be followed prior to any decision under Articles 85 and 86 on the national level, E.E.C. Commission, *THIRD GENERAL REPORT III*, 36 (1960); *BULLETIN OF THE EUROPEAN ECONOMIC COMMUNITY*, French ed. 49 (No. 1-60); *Bericht des Bundeskartellamtes über seine Tätigkeit im Jahre 1959*, Deutscher Bundestag, 3. Wahlperiode, Drucksache 1795, at 57 (196).

tices, the Commission shall authorize the injured Member State to take the appropriate countermeasures as determined by the Commission.

In order to arrive at a proper application of the mandates of Article 91(1), the Commission, on June 25 and 26, 1959, convened a conference of government experts from the six Member States. As the Treaty does not expressly define the term dumping practices, it was decided to utilize the definition given in General Agreement on Tariffs and Trade (G.A.T.T.) Article VI as a suitable working basis.⁶⁶⁹

Article 92(2) establishes a further palliative against dumping, by making it unattractive for the parties to engage in such practices because of a device described as "boomerang." Article 92(2) provides that, from the entry into force of the Treaty, goods that have been produced or have been in free circulation in one country and have been exported to another country may not be subject to customs duties, quantity restrictions or equivalent measures, if they are re-imported to the country from which they were exported. The details are left to a regulation of the Council. The pertinent regulation was issued on March 11, 1960.⁶⁷⁰

⁶⁶⁹ For details regarding the interpretation and enforcement of Article 91(1) see E.E.C. Commission, *THIRD GENERAL REPORT III* 38-40 (1960).

⁶⁷⁰ [1960] J'L OFF. 597.

Chapter XI

Taxation

*J. van Hoorn, Jr. and L. Hart Wright **

INTRODUCTION

This study on the foreign and United States tax implications encountered by American industry in rendering services, or disposing of products, in the European Common Market is designed for the benefit of those who have little or no understanding of the subject matter. While this analysis constitutes the most comprehensive published *integrated* study of the subject, it falls far short of answering every question with which a specialist in foreign tax affairs must ultimately come to grips. After all, the economies of the six nations which make up that market are almost as sophisticated as that in the States, and this means that their tax structures will be almost equally complicated. While those nations do not publish rulings and regulations in a degree comparable to the Federal practice, and thus do provide less raw interpretative data, nevertheless, one cannot expect in a few hundred pages to develop in meaningful sequence all of the known variations in their tax patterns, particularly if room is required to accommodate integration of relevant American tax principles and costs. The aim here does not go beyond providing detailed orientation to a degree that

* Most of the basic data concerning foreign taxes was prepared in the form of a rough draft by Mr. J. van Hoorn, Jr., in cooperation with the International Bureau of Fiscal Documentation (Herengracht 196, Amsterdam) of which he is the managing director. Mr. van Hoorn also serves as a tax consultant and is co-author of a three volume treatise in Dutch on the principles of taxation, "Het Belastingrecht Zijn Grondslagen En Ontwikkeling," (L. J. Veen's Uitgeversmij. N.V., Amsterdam, 1954, 2d ed.). In addition to authorship of other tax articles, he is director of the tax volumes in the twelve volume series, "Recueils Pratiques du Droit des Affaires dans les Pays du Marché Commun."

Revision of this Chapter into a final manuscript and original development of the materials dealing with American tax implications were the responsibilities of Professor Wright (Professor of Law, University of Michigan; formerly Professor of Tax Law, Advanced Training Center, Internal Revenue Service (1954-1956); Consultant to the Commissioner of Internal Revenue (1956, 1959-1960); author, "Basic Income Tax Law For Internal Revenue Agents and Office Auditors," Internal Revenue Service (1957); and author of various tax articles.)

one may formulate tentative plans and identify those questions which must then be referred to the specialist. To this end, the study is divided into six PARTS, the sequence being geared generally to the evolutionary stages through which an American business might logically expand its foreign operations.

PART I contains a country-by-country survey of the tax systems employed by the Common Market countries; it provides background essential to a true understanding of the tax differentials later dramatized by functionalized comparisons in PARTS II, III, and V. The discussion in PART I of each country's tax structure has been arranged according to a more or less common pattern. Consideration of a particular country's income and enterprise taxes is followed by an analysis of its property and turnover taxes. With respect to income taxes, immediately following a description of the overall tax pattern and the rate structure applicable to individuals and corporations, the focus shifts to the prevailing notion of gross income including the treatment of capital gains. An analysis of deductions and certain special problems follows. Included in the latter are accounting problems, the matter of taxable years, and differences in tax treatment where an American company establishes a foreign subsidiary, as distinguished from a permanent establishment in the nature of a branch.

The truly functionalized comparative study, including integration of American tax principles and costs, begins in PART II with an analysis of the overall tax effects encountered by an American company when it first seeks to enter the Common Market through development of direct exports to customers situated there. The first prime concern in that setting involves the extent to which promotional and sales activity can be carried on in the Common Market itself without subjecting any part of the export profits to their income taxes. Compared also are the turnover taxes which would be imposed by each member nation, including some indication of the way these may multiply, depending on the manner in which the sale is handled. Integration of these into the American tax pattern is followed by a consideration of the circumstances in which exports can be immunized from the manufacturers' excise tax. The direct export story then concludes with an analysis of the considerations which affect the competitive tax position of American exporters when compared to other exporters as well as with producers in the Common Market itself.

For a variety of reasons, an American exporter may conclude

that those products destined for foreign markets should actually be manufactured abroad, in whole or in part. Execution of a licensing and "know-how" agreement between the American company and an established European firm may be preferred by the less venturesome as against establishment abroad of an American owned manufacturing facility. A complementary motive may be to assure a ready outlet for certain components which will continue to be manufactured at home. In any event, second only to the development of direct export trade—where also little capital, if any, is ventured abroad—direct licensing arrangements enjoy the least complicated foreign tax effects. Accordingly, it seemed appropriate that the fairly simple comparative foreign income and turnover tax effects, including integration of American tax costs, should also be dealt with in PART II, immediately following analysis of the export situation.

Put off for discussion in PART III are the more sophisticated sales and licensing arrangements, involving use of the same organizational devices which might house a manufacturing facility, specifically a foreign permanent establishment in the nature of a branch or a foreign subsidiary. In order to facilitate comparison of the foreign tax effect on these in each of the member nations, the discussion in PART III proceeds first, in Sections B and C, on the assumption that a facility is to be established to serve only one member nation. Comparison is made in Section B of the total direct tax load (income, enterprise, and property taxes) which each country would impose if it were chosen as the locale. Integration in Section C of the American tax costs also provides the occasion for a basic analysis of the reasons why, and instances where, there are differences in the *overall* or combined tax costs of doing business through a foreign branch as distinguished from a subsidiary. Emergence of a differential which generally favors the subsidiary arrangement is traced, leading, *inter alia*, to a more or less complete discussion of the provisions regarding the deduction and credit for foreign taxes allowed by the United States in the setting of a single-tier foreign facility. Discussion of the limitations of the credit will serve, illustratively, to explain—in terms of preferred tax locales—why a country like Belgium, which relies primarily on an income tax, enjoys a relative advantage over a country like Germany which looks also to annual net wealth taxes on corporations as well as on individuals for a significant part of its direct tax revenue.

The foreign and American tax ramifications of the next stage in the life line of an expanding Common Market facility, i.e., the circumstance where it begins to engage in direct exports to customers in other member nations, is taken up in Section D of PART III. An analysis of the bilateral income tax treaties among nations of the Common Market is followed in that Section by an indication of the arrangements which serve to whittle down the likelihood of multiple turnover taxes. The Section concludes by supplying the reasons behind an admonition bearing on the tax considerations which should be taken into account in choosing a locale for that facility which will export into other member nations.

The succeeding Section E examines the further foreign and American tax ramifications which will arise if the *operating* facility in one member nation intensifies its development of markets in other member nations by establishing therein its own branch or a sub-subsidiary. Discussion of the extent to which there will be *two foreign* income taxes on the second facility's profits—the likelihood depending on the organizational nature of the facility and the choice of locale, is followed by an examination of the way the American credit for foreign taxes would respond to such a two-tier arrangement.

Compared with the foregoing, in the following Section F, are the tax implications which would be associated with the American parent company's own establishment of "sister" branches or subsidiaries.

Widespread and expanding operations of that type logically focus attention, in Section G, on the tax advantages which could be achieved if a foreign holding or "base" company were superimposed on the operating facilities, provided, of course, a favorable tax climate for the holding company could be found. The importance of this latter condition is highlighted by comparing, as possible locales, certain Common Market countries with certain so-called "tax havens" located adjacent to that market, the indication being that the Netherlands and in a lesser degree, Luxembourg, provide a tax regime as favorable as any.

PART III then concludes with an indication of the tax implications encountered where a foreign facility in the Common Market exports directly to customers outside the Community.

It seemed unwise to interrupt PART III's evolving and integrated tax story of an expanding and ever more penetrating foreign operation with diversions into certain American tax matters which,

together, might be subsumed under a tax accounting label. Accordingly, the methodology and timing aspect, as they relate to conversion of foreign profits into American dollars, are covered in PART IV in the setting of blocked as well as unblocked foreign currencies. Also dealt with there is the conversion problem as it relates to the American credit for foreign taxes.

Even the most simple penetration of a foreign market, a direct export arrangement, may lead an American company to assign certain American employees abroad as promotional representatives. The likelihood is even greater if a permanent establishment or subsidiary is created in the Common Market. The function of PART V is to compare the foreign tax loads which would be imposed on such persons, indicating at the same time the way in which American tax law responds to the situation. Foreigners employed by the Common Market facility, as well as Americans stationed there, may be expected to make brief business visits to the States—combined perhaps with a vacation. Other Americans, normally stationed in the States, may also make brief business trips abroad. The ensuing tax complications and the degree to which the interested nations have avoided double taxation in these circumstances, are also subjects of discussion in PART V.

Whereas the first five PARTS are concerned with the tax pattern existing in July 1960,¹ PART VI attempts to survey changes which might be expected in the future with respect to Common Market taxes and such American tax principles as affect companies interested in the market outlet provided by the European Economic Community.

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- Germany: Dr. Albert J. Radler, Dipl. Kfm., Munich

¹ After the original manuscript was prepared, PART III was revised to accommodate certain changes made in August 1960 by Congress.

(Assistant in the Institute of International Tax Law at the University of Munich); and

- Italy: Dr. Giancarlo Croxatto, Genoa (Assistant, University of Genoa; co-author of various publications in the field of international tax law, national reporter to the 12 volume, "Recueils Pratiques du Droit des Affaires dans pays du Marché Commun").
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PART I. THE TAX SYSTEMS OF COMMON MARKET COUNTRIES

(*A Country By Country Survey*)

SECTION A. BELGIUM

SUBSECTION I. INCOME TAXES

(a) *In general.*—Unlike the single federal income tax utilized by the United States, the Belgian national government employs a series of different income taxes. Income of individuals and juridical entities is first divided by reference to its type into three primary categories, each of which is subjected to a different tax. A fourth tax, applicable only to individuals, is superimposed on these separately scheduled assessments; it is applied to the *aggregate* income from the three primary sources. A fifth tax, enacted during the critical days of the 1930's and known as the Contribution Nationale de Crise, is imposed on selected items of income belonging to two of the three primary categories, as well as on distributed profits of some juridical entities.

The first of the prime categories comprises income from all *real* property situated in Belgium. Whereas gross income for American tax purposes would normally include the *actual* income from such property, only an estimated amount has been included in Belgium. This estimate, made according to a Land Register (*cadastre*), is often much less than the actual income. Once made by reference to average net yield, the estimate thereafter remains constant for a period of 20 years. The contemplated periodic revision of the estimates has not been undertaken in recent years, though a new estimate—expected to be much closer to actual income—is under consideration.^{1a} This “income” is subject to a modest *flat* rate national tax (Contribution Foncière); to this is added the progressive rate of the national crisis tax and substantial local surcharges.

Another, but different, flat rate tax (Taxe Mobilière) applies to *actual* income from investments in *personal* property, though here

^{1a} This method has the advantage that the tax will be the same, irrespective of whether the property is used by the taxpayer himself or leased.

variations in the flat rate do exist, depending on whether the income item is a dividend, interest, royalty, etc. It applies also to income from *real* property situated abroad. Where such an investment is made by a silent partner of a partnership or of a Belgian private company, the income is subject also to the national crisis tax and at progressive rates. Foreign partnership or private company income is subject to $\frac{1}{3}$ rd of the ordinary rates of this latter tax.²

A graduated tax, known as the *Taxe Professionnelle*, is applied to the third basic type of income, i.e., to that derived from the conduct of a trade or business, including also professions, vocations, or an employment. Corporations with outstanding shares may avoid the greater part of this *progressive* tax by distributing their profits. But in such case, a flat rate tax under the selective *Contribution Nationale de Crise* is assessed against the corporation by reference to the amount of the gross dividend. At that same point the shareholder would be assessed under the basic, separately scheduled and previously described, flat rate *Taxe Mobilière*.

A final type of tax (*Impôt Complémentaire Personnel*) is applicable only to individuals. It is designed to apply a graduated rate to the individual's aggregate income from the three basic sources first mentioned (real property, personal property, and business or employment activity).

A more detailed analysis of the cumulative effect of these various taxes follows.

(b) *Taxes on estimated income from realty.*—Apart from the progressive tax on an individual's aggregate income from all sources, at least three different taxes are applied to administratively determined advance estimates of "imputed" income derived by juridical entities or individuals from ownership of real property. The first, a national 6% flat rate, is complemented by the graduated national crisis tax, the progressive rates of which range from 2 to 15%. Local units then surcharge the national flat rate imposition, and these surcharges are said to approximate an average rate of about 36%.³ Table I A indicates the cumulative effect of the three rates.

One procedure, very similar to that followed by American states in imposing real property taxes, has served in practice to cushion what might seem to be a rather high cumulative rate pattern. The

² For the tax treatment of foreign income, see sub-topic (j), *infra*.

³ This average differs from that given in a Belgian official publication, where a figure of 30% is used.

TABLE I A
REAL PROPERTY RATE SCHEDULE

<i>Belgian Francs</i>		Estimated Income				<i>Additional Tax (Local Gov't)</i>	
		<i>Dollars</i>		<i>% re Flat</i>	<i>% re the National</i>		
<i>From</i>	<i>To</i>	<i>From</i>	<i>To</i>	<i>Rate Tax</i>	<i>Crisis Tax</i>	<i>Average %</i>	<i>Total %</i>
0	2,999	\$ 0	\$ 59	6	2	36	44
3,000	9,999	60	199	6	3	36	45
10,000	24,999	200	499	6	4	36	46
25,000	49,999	500	999	6	6	36	48
50,000	99,999	1,000	1,999	6	8	36	50
100,000	149,999	2,000	2,999	6	10	36	52
150,000	199,999	3,000	3,999	6	12.5	36	54.5
200,000 and over		4,000 and over		6	15	36	57

administratively determined amount of estimated income from each piece of real property remains unchanged for long periods of time. Because the economic criteria used in fixing the present effective base pre-dates the Second World War, the amount of estimated income assigned to any given piece of real property is *not* nearly as high as the present *true* annual use value. The *effective* base, according to one authority, constitutes not more than one-fifth of the true amount. This compensating factor is offset in part, but only in the case of real property used in connection with industrial activity, in that the base otherwise determined is increased by one-half.

Accordingly, if the *true* annual use value of a small factory building and the tract of land on which it is situated approximates \$6,000 (B.Frs. 300,000), the taxable estimated income is not likely to exceed \$1,800 ($\$6,000 \times \frac{1}{3} \times 1\frac{1}{2}$) for which the typical stated cumulative average rate is 50% or \$900, which means an effective rate of 15%.

(c) *Taxes on income from investments in personalty.*—The Taxe Mobilière, generally collected on a withholding basis, incorporates different flat rates for various types of income derived from investments in personal property. Dividends received from companies, the capital of which is divided into shares, are taxed at 30% while debenture interest and royalties are taxed at 18% though this latter rate is reduced approximately to 12.2% if the debtor, rather than the creditor, actually bears *and* pays the tax.⁴

⁴ Profits distributed to a silent partner of a partnership are taxed at 25% under the Taxe Mobilière and at 2% to 15% under the national crisis tax.

Assessment of this tax against stockholders with respect to dividends is complemented by a flat rate national crisis tax, assessed against the corporation, on the same gross dividend. Moreover, if the shareholder is an individual, the dividend will be aggregated with his other income in fixing the base against which a third tax, the progressive *Impôt Complémentaire Personnel*, is applied. These two additional taxes are considered in more detail below.

The *Taxe Mobilière* is also applicable to income from foreign real property, but, as is true in the case of income from foreign personalty, the rate is reduced to a flat 12%.

(d) *Taxes on retained income from trade or business activity.*—The *Taxe Professionnelle* applies a graduated rate to income derived from a profession, employment, or from trade-or-business activity carried on by corporations, partnerships, or individuals. It differs from the American federal income tax in two major respects. First, income from investments in personal property, such as stocks or bonds, as well as any imputed income derived from real property is beyond the reach of this particular tax. Second, in the case of corporations and partnerships, this exaction is only applied to *undistributed* profits. The type of taxes applied to *distributed* profits depends, as is later noted, upon the character of the distributing juridical entity. Because these latter taxes do serve as a substitute for the *Taxe Professionnelle* in the case of distributed profits, a credit arrangement has been worked out to accommodate those situations where retained profits which have been subjected to the *Taxe Professionnelle* are distributed in a later year, at which time they become subject to the other taxes.

The progressive rate schedule of the basic tax applicable to undistributed business profits of juridical entities appears in Table I B.

TABLE I B

On That Part of Taxable Income:		
<i>Belgian Francs</i>	<i>U.S. Dollars</i>	<i>Rate</i>
From 0 to 150,000	From \$ 0 to \$ 3,000	25.0%
From 150,000 to 500,000	From 3,000 to 10,000	30.0%
From 500,000 to 1,000,000	From 10,000 to 20,000	35.0%
From 1,000,000 to 10,000,000	From 20,000 to 200,000	37.5%
From 10,000,000 and over	From 200,000 and over	40.0%

In appraising this schedule, account should be taken of two additional factors. First, the *Taxe Professionnelle* is actually levied on the income of businesses and liberal professions in the year

following the year in which the income was derived, and in principle the amount, as distinguished from the rate, of tax is increased by 20%. But this increase may be avoided *en toto* if the ultimate tax was accurately estimated and paid in advance, i.e., before the 15th day following the first half of the taxpayer's taxable year (accounting year). Again, the increase will amount only to 10% if an accurate estimate was made and paid before the 15th day following the close of the taxpayer's taxable year. Absent advance payment, or where the amount paid in advance is less than the tax ultimately due, the amount which has not been paid in advance is increased by 20%. In effect, the portion of the income not reflected in the estimates would, if otherwise subject to the 40% rate, suffer a 48% rate.

Second, unlike the American income tax, on the *final* due date in the year succeeding the taxable year, the professional tax becomes a deduction in computing the taxable profits of that same succeeding year. The effect of this feature can be illustrated by reference to that part of any yearly profits subjected to the stated 40% ceiling rate. In the first year in which an enterprise operates, that ceiling rate would, of course, be the effective rate on income falling in the top bracket. In the second year, the stated 40% rate on such income would become an effective 24% rate, and in the succeeding years, the stated 40% rate would be tantamount to a shifting effective rate ranging between 30% and 28%.

The quite different rate schedule, applicable under the *Taxe Professionnelle* to the net business or employment income of an individual, is presented in Table I C.

TABLE I C
RATES ON NET INCOME AFTER ITEMIZED OR
STANDARD DEDUCTIONS

On That Part of Taxable Income:				
Francs		Dollars		Tax Rate
From	To	From	To	
0	150,000	\$ 0	\$ 3,000	From 0 to 27.5%
150,000	250,000	3,000	5,000	27.5%
250,000	500,000	5,000	10,000	30.0%
500,000	1,000,000	10,000	20,000	32.5%
1,000,000 and over		20,000 and over		35.0%

The remuneration of corporate directors who are members of the board of control and do not have a regular job with the company is subject to the normal rates with a 20% surcharge.

This surcharge is independent of, and its application will precede, the quite different and previously discussed additional tax of 20% which is applied against the amount ultimately due if the latter was not paid in advance either through withholding or estimated payments. Illustratively, if a corporate director's basic rate under the regular income tax is 30%, the special surcharge added with reference to remuneration received as a director will increase the rate to 36% ($20\% \times 30\% = 6\%$), and this will be increased again by another 20%, bringing the rate to 43.2% ($20\% \times 36\% = 7.2\%$), if not paid in advance.

Generally, the tax on salaries and wages (including those paid to company directors) is withheld at the source, the exception being the tax payable by managers (working partners) of the so-called *sociétés de personnes* (partnerships, limited partnerships, and closely held corporations).

(e) *Taxes on distributed profits of an enterprise.*—As previously noted, the Taxe Professionnelle applies only to *undistributed* business profits. Selection of the particular taxes which apply to distributed profits turns on the character of the distributing juridical entity.

Entities, the capital of which is divided into shares, pay a flat national crisis tax of 20% on *gross* dividends. Viewed separately, this would mean that a corporation would need a profit of \$120 in order to distribute a \$100 gross dividend. However, since the \$20 is not itself distributed, the corporation will also be burdened with the Taxe Professionnelle, which at the maximum 40% rate, would give rise to an additional tax of \$8 on the \$20 of retained earnings. The overall maximum effect is that a corporation must enjoy a profit of \$128 in order to pay a \$100 dividend.⁵ The two taxes just described will then be complemented by the previously discussed personal property income tax (Taxe Mobilière), assessed on a withholding basis, against the shareholder, the rate being a flat 30% against the gross dividend of \$100. Apart then from the yet separate progressive tax on an individual's aggregate income from all sources, that part of a corporation's profits which is distributed will suffer a maximum tax of approximately 45% ($\frac{20 + 8 + 30}{128}$).

Where the capital of a jointly conducted enterprise is not divided

⁵ It must be understood that this is the maximum possible effect. As the share of current profits which are distributed increases, the likelihood that the enterprise will reach the stated rate of 40% under the Taxe Professionnelle decreases. Moreover, that part of the Taxe Professionnelle attributed to retained profits used to pay the national crisis tax will become a deduction in computing a later Taxe Professionnelle. This would whittle the true effective cost to a figure below \$8.

into shares, any portion of the profits distributed to *active* partners is subject to two different progressive taxes. The first involves the progressive rates under the *Taxe Professionnelle* applicable to individuals, the second being the complementary personal tax which applies a graduated rate to an individual's aggregate income from all sources. Distributions to *silent* partners of such an enterprise are subject, on the other hand, to three different taxes, the personal property income tax (*Taxe Mobilière*) at a flat 25% rate, a graduated national crisis tax ranging from 2 to 15%, and the regular progressive income tax applicable to an individual's aggregate income. However, the first two of these taxes constitute deductions in arriving at the tax base of the third.

(f) *Complementary progressive tax on individual's aggregate income.*—In addition to the three separate taxes on income from personal property, real property, and business, individuals pay a graduated tax with respect to the aggregate income from all of these sources. However, the three separately scheduled taxes as well as any overall complementary progressive tax paid during the period are deducted from gross income in arriving at the tax base against which the overall progressive tax is applied. These deductions, together with certain deductible personal items to be discussed later, are important in appraising the actual impact of the graduated rates in Table I D.

TABLE I D
TAXABLE INCOME

	<i>Francs</i>	<i>Dollars</i>	<i>Rate</i>
First	50,000	\$1,000	0.5%
Next	50,000	1,000	3 %
Next	50,000	1,000	5 %
Next	50,000	1,000	10 %
Next	50,000	1,000	14 %
Next	50,000	1,000	20 %
Next	300,000	6,000	24 %
Next	200,000	4,000	26 %
Next	200,000	4,000	28 %
Balance	—	—	30 %

(g) *The Belgian concept of gross income.*—The types of income embraced by the various basic taxes have been previously described. Since most of the previously mentioned income taxes relate to narrowly defined items, the practical meaning of gross

income need be considered only in the setting of the more far ranging progressive tax on business income and the complementary progressive tax on an individual's aggregate income. Compared to American standards, the most unique principle relates to the treatment of capital gains and income which is not *ordinary* business income.

Generally speaking, such gains do not constitute a part of gross income. The range of this immunizing principle is limited, however, by the fact that any gain realized from the sale of specific business assets is considered a business profit and is taxed under the applicable rate schedules as such. There is some recognition that such gains are illusory to the extent they are products of a piecemeal inflation which started in Belgium following World War I. The formula used in determining the amount of gain allows the vendor first to increase the historical cost basis by a coefficient, the amount of which depends on the year in which the asset was acquired. From the sum thus determined, depreciation previously allowed for tax purposes is deducted in arriving at the net basis. Table I E presents a schedule of the coefficients.

With reference to the Taxe Professionnelle, as well as the complementary progressive tax on income derived by individuals from

TABLE I E

<i>Date of Acquisition</i>	<i>Coefficient</i> ^o
1918 and before	16.33
1919	11.49
1920	6.15
1921	6.30
1922	6.43
1923	4.37
1924	3.89
1925	4.02
1926	2.72
1927 to 1934 inclusive	2.35
1935	1.86
1936 to 1943 inclusive	1.70
1944 to 1948 inclusive	1.14
1949	1.10
1950 et seq.	1.0

^o These coefficients apply only to industrial or commercial buildings and equipment, as well as to securities held for more than five years.

all sources (Impôt Complémentaire Personnel), a further immunity has been granted, but only temporarily—i.e., during the calendar years 1959 to 1963 or counterpart fiscal years, if the realized gain from the disposition is reinvested within a certain period. Satisfaction of the prescribed standard leaves only $\frac{1}{5}$ th of the gain subject to tax. And none of the gain will be recognized if the reinvestment is made in certain districts which have suffered particularly serious economic dislocations.

The fact that gain realized on the disposition of business assets is generally includible for tax purposes also has significance in the instance where a proprietorship is converted into a limited liability company. The gain, determined by subtracting the net basis just described from the fair market value of the shares received, will be taxed unless the owner himself ceases all trade. In the latter event, only the profit stemming from the transfer of goodwill (clientele) is reached.

With reference to a business's income, it will be recalled that only income from actual business activity is subject to the professional tax. Dividends received by enterprises (other than those which operate in the financial field as such) are subject to the personal property income tax (Taxe Mobilière) but are excluded⁷ from both retained or distributed income of the enterprise for the purpose of computing its other taxes. In other words, dividends received by an enterprise are taxed under a complementary progressive tax only to its shareholders. The same applies to other investment income as well as to royalties (except where the enterprise mainly or exclusively exploits patent rights) and to income from immovable property (again, except in the case of a building society or the like) the estimated amount of which is subject to previously described special taxes. Finally, it bears repeating in connection with the professional tax that only retained profits are taken into account.

(h) *The Belgian concept of "taxable" income.*—Deductions which may be taken from gross income in arriving at the tax base are primarily important only in connection with the tax on business or employment income, and with respect to the complementary tax paid by individuals on their aggregate incomes. While the special tax on income from personal property is also geared to a concept of *net* income, the fact is that expenses in such settings—illustratively

⁷ This method is similar to the dividends received deduction allowed in the United States, only the percentage is 100 instead of 85.

with respect to dividends—are not frequently incurred. But where expenses are suffered in acquiring such income, e.g., banker's fees, they may be deducted. On the other hand, the special tax on "estimated" income from real property is *not* geared to *actual* income, gross or net. As a consequence, actual expenses may not be deducted from the tax base fixed by the administrative authorities.

The net income concept employed by the special tax on business income is quite similar to that used in the United States. Permissible deductions include wages, salaries, rent paid for the use of personal property, interest—including any reasonable amount which a subsidiary pays a parent in connection with a loan, indirect taxes, such as those on sales, and depreciation.

The provisions regarding depreciation are not, however, quite so favorable as they are in the United States. Accelerated depreciation methods which are available in America are not generally allowed, though in particular cases, for example in the case of ships, the useful life over which the property may be written off is relatively short. Depreciation is generally based on the straight line method as applied to historical cost, though other methods may be used as long as they follow the diminishing value of the asset. Depreciation on the basis of replacement value is not allowed except that the historical cost of certain assets has been hiked by a formula in that instance where the asset was acquired before World War II and was still in use thereafter.

For the calendar years 1950 and 1960, and counterpart fiscal years, a type of investment allowance has been created with respect to the Taxe Professionnelle, but not for purposes of the complementary graduated tax on individuals. This allowance, applicable only to certain investments, amounts to 30%, and is to be spread evenly over a 3-year period.

The treatment of closing inventories corresponds roughly to practices followed in the United States. Normally closing inventories must be valued at cost or market, whichever is lower. However, in identifying the goods on hand, neither LIFO nor the base stock method may be used.

The most striking departure from American practices involves the provision which permits taxes on business income to be deducted in the year finally due in computing the business income of that year. The degree to which this practice reduces the impact of a theoretical rate structure has been previously considered.

In the case of individuals on salary or wages and others engaged in the exercise of a liberal profession, a standard deduction, set at $\frac{1}{4}$ th of the gross income, is allowed to accommodate their *business* expenses. However, the standard deduction includes a ceiling. It may not exceed B. Fr. 60,000 (\$1,200) plus deductible taxes.⁸ To avoid this ceiling, a taxpayer is required to itemize his deductions and must be prepared to submit appropriate evidence that they do in fact exceed the standard allotment. Though this tax (*Taxe Professionnelle*) is imposed on business income, certain personal deductions as well as credits for dependents are allowed. These are identical to those applicable in the case of the complementary tax on an individual's aggregate income.

The personal deductions common to both taxes involve premiums paid for life insurance and old age pensions. And, in both cases, a credit against taxes payable on the first B. Fr. 250,000 (\$5,000) may be taken with respect to dependents. These credits range from 5% of the tax in the case of one dependent to 100% in the case of 8 dependents.⁹

Since the complementary tax on an individual's aggregate income is intended to reach only his aggregate *net* income, deductions allowed with respect to the other three separately scheduled basic taxes are in effect also allowed. In addition, a deduction may be taken against his gross income for the amount of those separately scheduled taxes as well as for the aggregate income tax paid in that year. A deduction is also allowed for interest paid on non-business loans and for alimony. Finally, 15% of business or employment income, otherwise subject to the *Taxe Professionnelle*, may be deducted, to a maximum of B. Frs. 30,000 (\$6,000).

(i) *Payment and the taxable year.*—All of the previously described taxes are assessed on a yearly basis. Only in the case of the tax on business income may losses of one year be carried forward to offset gains of a later year. This carryover, limited to 5 years, is not complemented by provisions regarding carrybacks.

The taxes on estimated income from real property and on actual income from personal property (*Contribution Foncière* and *Taxe Mobilière*) are paid in the year in which the income is realized. For example, the income tax against a stockholder, deducted at the

⁸ In the case of company directors, the standard deduction equals 5% of their gross income plus deductible taxes.

⁹ 10% for 2 dependents, 20% for 3 dependents, 30% for 4 dependents, 50% for 5 dependents, 70% for 6 dependents, 90% for 7 dependents.

source on the distribution of a dividend, is the tax for the year in which the dividend is received. The tax on business income (*Taxe Professionnelle*), on the other hand, is not due in a final sense until the year immediately following the taxable year. However, as previously noted, unless payment is made in advance, the taxpayer will suffer a substantial increase in the effective rate. For example, in early 1960 a corporation must estimate its profits for that year *and* also anticipate the amount which will be distributed. Assuming a calendar year taxpayer, the tax on the anticipated undistributed profits must be paid before July 15 of 1960; otherwise the first of the previously described increases in the tax will take effect.¹⁰ It is important to understand that the advances are truly pre-payments. For example, when it is said that the *Taxe Professionnelle* is a deduction in computing the profits for a given year, the deduction in our example would take place in the succeeding year, 1961, when the tax is finally due, not in the year in which payment was made on account. The tax administration recognizes, as an extra-statutory concession, that taxes paid may be deducted even if the taxpayer has not yet received an assessment.

(j) *The relevance of residency, and the comparative cost of retaining and accumulating income.*—Only in the case of the tax on income from real property situated in Belgium (and the national crisis tax applicable thereto) is the reach of the tax law the same with regard to residents and non-residents.

Residents and entities domiciled in Belgium are reached by the other taxes without regard to the place from which the income originated. But where the income originated and was taxed abroad, a reduced rate is applied. On business income of this type, the rate under the *Taxe Professionnelle* is $\frac{1}{5}$ th of that normally applied. And where a corporation distributes such foreign earned income, its own national crisis tax is only $\frac{1}{5}$ th of the normal 20% rate. Also, instead of the regular 30% rate applied to the recipient shareholder, a flat 12% is assessed on dividends distributed out of such foreign income. Again, the graduated rate of the national crisis tax normally applicable to silent partners with regard to such distributed profits is reduced to $\frac{1}{3}$ rd of the normal rate.

The place from which income originated is also important in the case of non-residents and corporations domiciled outside of Belgium. As is generally true of other countries in such circumstances,

¹⁰ The increase, 10% of the amount otherwise payable, is hiked to 20% if payment is delayed beyond the 15th day following the close of the taxable year.

Belgium asserts its jurisdiction only with reference to income which has its source there.

But assuming for the moment that Belgium is the source of income derived from business activity, the particular business form in which that operation is conducted can also make a great deal of difference in the way in which three significant taxes are applied. Assume, for example, that an American enterprise also plans to operate a facility in Belgium. If that facility is housed in a subsidiary corporation domestic to Belgium the business profits—so long as they are retained—will be subject only to the graduated Taxe Professionnelle, the *stated* rates ranging from 25% to 40%.¹¹ However, because the amount of such tax due in one year is deducted in computing the business profits of that year, any profit which falls in the stated 40% rate will not, following the first year, be taxed at an effective rate in excess of 30%.

A corporation which desires to use its profits for expansion may capitalize those earnings¹² by distributing stock dividends.¹³ These are not considered taxable income in Belgium. However, the capitalization will be more expensive than leaving the profits in the form of surplus, for certain registration duties and fees are encountered.

On the other hand, where profits of a subsidiary are distributed in cash, the effective combined ceiling rates of the various taxes will be one third higher, i.e., will be 45.3% determined as indicated in Table I F.

TABLE I F
TOTAL TAXES ON DISTRIBUTED PROFITS
OF SUBSIDIARY

Stated rate of national crisis tax against subsidiary; payable from undistributed profits, and applied to gross dividend.	Stated ceiling rate of Taxe Professionnelle, applied against that part of undistributed profits used to pay national crisis tax.	Stated flat rate of Taxe Mobilière, against the shareholder on w/h basis re gross dividend.	Effective combined ceiling rate of all taxes.
20%	$40\% \times 20\% = 8\%$	30%	$\frac{20 + 8 + 30}{128} = 45.3\%$

¹¹ Of course, the tax on any estimated income from real estate will be applied whether or not profits are distributed and without regard to the form of the enterprise.

¹² It should be noted that Belgium does not have any penalty taxes on accumulated profits.

¹³ These should generally be issued in a later year than that in which the profits have been made.

If profits are to be distributed instead of being ploughed back for expansion purposes, there will be some tax saving to the subsidiary as well as to the parent if the investment is represented in part by loans reflected in a bond issue to the parent. Interest, but not beyond a reasonable amount, constitutes a deductible expense to the subsidiary, and the tax to the parent on interest is 18% (12.2% if the subsidiary bears *and* pays the tax), contrasted with the 30% tax on dividends.

If the facility is operated as a branch of the American parent, rather than through a subsidiary, the very form of the operation rules out "dividends" as such. The parent will own the profits of the branch as they come into being. Thus the national crisis tax and the Taxe Mobilière, which normally apply to dividends, are rendered inapplicable. The foregoing is another way of saying that in this setting the question of whether profits are retained or distributed is immaterial. The Taxe Professionnelle reaches the *entire* profit in either case. But instead of the graduated rate applicable to local corporations, in this instance Belgian law applies a *stated* flat rate of 40%. But again, the fact that the professional tax due in one year is deducted in computing the business profits of that year means that, in the second and succeeding years, the effective rate will not exceed 30%.

Nonresident individuals suffer the progressive tax on aggregate income only where they hold a dwelling house situated in Belgium or exploit a permanent establishment located there, and then only to the extent income is derived from these sources.

(k) *Disposition of an enterprise.*—As in the United States, the Belgian tax provisions relating to the disposition of an enterprise are rather complex. Accordingly, only a general comment can be made here. If a corporation disposes of its assets, any realized gain to it is, in principle, taxable income. However, the bases of the assets are multiplied by a coefficient before determining the amount of its gain. If the proceeds are then distributed to the stockholders (or to silent partners in the case of the *sociétés de personnes*), the distributed amount will be subjected to three taxes (national crisis tax, personal property income tax, and the complementary progressive tax) to the extent the stockholder's basis (the capital originally paid in), multiplied by a coefficient, is exceeded by the distribution. However, the impact of the first two of these is cushioned by what is tantamount to a credit equal to that tax paid by the enterprise on that business income which in turn is being distributed.

SUBSECTION 2. OTHER SIGNIFICANT TAXES

(a) *Belgian taxes on capital and property.*—Belgium does not utilize a property tax as such. But if real estate is transferred for consideration in money or money's worth, a so-called registration duty is payable. The rate normally depends on the character of the person to whom the transfer is made and on the nature of the real estate transferred. The normal rate of 11% of the selling price or value is whittled down, in the case of sales to charitable institutions, to 6% and in some cases to 1.5%. The rate is also 6% with reference to sales of small lots and modest dwelling houses.

Incorporation of assets or subsequent increases in paid-in capital also give rise to fairly significant registration duties, the rate being 1.6% in the case of Belgian companies. Nonresident companies which have a "permanent establishment" in Belgium must also be registered there and must pay .1% on total paid-in capital with a ceiling, however, of 1,000,000 Belgian francs (\$20,000) and a minimum of 18,000 francs (\$360). With reference to its real estate, a registration duty of 1.6% is levied.

Belgium also employs a gift tax, but, unlike the arrangement in the United States, the complexion of the tax is similar to that of the Belgian inheritance tax. The latter is levied not on the estate as such, but on each individual acquisition by heirs or legatees. In the case of both taxes, the rates depend on the relationship between the donor (deceased) and the donee (heirs or legatees) as well as on the value of the acquisition. Both taxes are generally imposed only where the donor (deceased) is domiciled in, or is a resident of, Belgium. However, real estate constitutes an exception to this rule; donative or testamentary transfers of such are reached if the property is situated in Belgium.

(b) *Taxes on turnover.*—Income taxes are supplemented in a most significant way by turnover taxes on transfers of unfinished as well as finished products and on licensing, royalty, and many service contracts.

The general turnover tax (*Taxe de Transmission*), normally carrying a rate—except for luxury items—of 5%, is a multiple stage arrangement in that it applies to each transfer which may take place in the course of developing a finished product, the only important exemption relating to a transfer to the ultimate *individual* consumer. The importance of this exemption is not to be discounted, for the product at that point will have reached its maximum value.

Since the tax on each successive vendor, in the chain of those who contribute to the finished product, includes the value on which his predecessor had paid as well as the value added, goods which are converted by one taxpayer from the basic raw material into the finished product will normally suffer less tax cost than will goods which have to go through several hands.¹⁴

In the case of imports, the tax is first assessed at the point of importation.¹⁵ However, presumably for the purpose of facilitating exports, an *exporter* may acquire unfinished goods free of the tax and may also export the finished product free of the tax.

The other turnover taxes are complementary to the Taxe de Transmission (luxury tax and similar taxes), and include taxes on the rendition of services, royalties, transport, etc.

(c) *Other miscellaneous levies.*—Among other miscellaneous taxes are (1) stamp duties which are levied on instruments and documents, (2) excises imposed on the production or importation of certain commodities such as beer, wine, and tobacco, and (3) amounts levied annually by reference to the horse-power of passenger or freight motorcars.

SECTION B. FRANCE

SUBSECTION I. INCOME TAXES

(a) *In general.*—Since 1948, the over-all income tax arrangement regarding individuals has differed from that applicable to corporations, though in the case of profits derived from industry and commerce a more or less common tax base has been used.

Until 1959, individuals were subjected to two different income taxes. The first, a proportional income tax (Taxe Proportionnelle), was geared to a system of separate schedules which differed in that each reached a different type of income. Though the tax was separately applied to each of the various sources, after 1948 a more or less common rate had been used. The second tax (Surtaxe Progressive) was a surtax levied on the individual's *aggregate* income from all sources and at progressive rates.

For this dualistic individual income tax system, a reform in December 1959 substituted a single general tax on income. Gen-

¹⁴ On 31 goods, there is a special non-multiple tax. This contractual transmission tax is designed to avoid differences which would otherwise arise depending on the number of hands through which they pass.

¹⁵ Details regarding the application of turnover taxes to imports are more fully considered in Section A of PART II, *infra*.

erally speaking, this new tax is assessed according to those rules which had governed the old progressive surtax. For budgetary and psychological reasons, the old proportional tax with its separate schedules was not abolished outright. In other words, the reform is to be implemented in stages. At the moment, the proportional tax temporarily survives under the name of "Taxe Complémentaire," but at a considerably reduced rate. The rates of the old progressive surtax, operating now under its new name (Impôt sur le Revenu des Personnes Physiques), were increased. Also special measures were taken to see that income previously exempt from the old proportional tax (e.g., wages and salaries) will now be fully taxed.

On the corporate side, generally speaking, there is only one income tax (Impôt sur les Sociétés), and it is imposed at a flat rate. Partnerships (*sociétés en nom collectif*) may also elect this treatment instead of one which would subject the individual partners to individual income taxes on their respective distributive shares.

A third arrangement (*versement forfaitaire*), applicable to every business enterprise, is intimately related to the income tax scheme. Before the recent reform, instead of requiring that wages and salaries be included in one of the proportional tax schedules filed by employees, *employers* themselves suffered an assessment geared to three different rates, the choice depending on the total amount of annual remuneration paid a given employee. This arrangement survived the reform. Moreover, as before, employees will continue to include wages and salaries for purposes of the separate progressive surtax.

Employers will pay the *versement forfaitaire* at the rates as shown in Table I G.

TABLE I G
SCHEDULE

Remuneration		Rate Ap- plicable to the Portion Indicated
New Francs	Dollars	
0 to 30,000	\$0 to 6,000	5%
30,000 to 60,000	6,000 to 12,000	10%
Excess over 60,000	Excess over 12,000	16%

In any case where an employer does not suffer the *versement forfaitaire*, e.g., with reference to wages paid French employees by *foreign* employers, the employee himself pays this tax.

The question of whether a company director's remuneration is assessed against him or is instead assessed as a charge against the employer-company by reference to the above described rates of the versement forfaitaire, turns on whether his duties go beyond those normally performed by directors and are such as to give rise to the additional relationship of employer and employee. In this connection, managing directors are generally considered employees. In the case of private companies (*sociétés à responsabilité limitée*), special rules exist.

By statute all dividends are subject to a 24% withholding tax which normally serves as a credit against the recipient's general income tax. A bilateral treaty with the United States reduces the rate to 15% in the case of dividends paid residents or entities in the United States, and when the recipient is an American parent of a French subsidiary, this will normally constitute the final levy against the parent.

A statutory withholding pattern similar to that above applies to interest paid foreigners, except that the withholding rate on interest from French industrial bonds is only 12%.

(b) *The progressive surtax on an individual's income.*—The income tax, levied on an individual's *aggregate* income from all sources (including wages or salaries subject to the versement forfaitaire), conforms to the graduated rates as in Table I H.

TABLE I H

<i>Aggregate Taxable Income</i>		<i>Rate Ap- plicable to the Portion Indicated</i>
<i>New Francs</i>	<i>Dollars</i>	
0 to 2,200	\$0 to 440.	5% ^a
2,200 to 3,500	440. to 700.	15% ^a
3,500 to 6,000	700. to 1,200.	20% ^{a, b}
6,000 to 9,000	1,200 to 1,800.	25% ^{a, b}
9,000 to 15,000	1,800 to 3,000.	35% ^{a, b}
15,000 to 30,000	3,000 to 6,000.	45% ^{a, b}
30,000 to 60,000	6,000 to 12,000.	55% ^{a, b}
Excess over 60,000	Excess over 12,000	65% ^{a, b}

^a For salaries and wages etc. subject to the versement forfaitaire, rates are 0%; 10%; 15%; 20%; 30%; 40%; 50%; 60%, respectively.

^b An additional surcharge of 10% of the tax otherwise computed is applied if taxable income exceeds 6,000 N.F. or \$1,200.

The effect of the foregoing rate schedule is cushioned by an arrangement which is applicable to married persons or those with

dependent children and is similar to the "split-income" arrangement allowed under American law. In the case of a married couple *without* dependent children, the figures for a given income bracket are doubled though the rate remains constant. One dependent child counts just one-half as much as a spouse. Whereas the coefficient for a married couple is 2, it is $2\frac{1}{2}$ for a married couple with one child and would, by way of further example, be 3 if they had two children. Accordingly, the graduated scale reflected in the schedule set forth in Table I H would be modified in the case of a married couple with one dependent child, the coefficient being $2\frac{1}{2}$, as shown in Table I I.

TABLE I I

<i>Aggregate Taxable Income</i>		<i>Rate Applicable to the Portion Indicated^a</i>
<i>New Francs</i>	<i>Dollars</i>	
0 to 5,500	\$0 to 1,100	5%
5,500 to 8,750	1,100 to 1,750	15%
8,750 to 15,000	1,750 to 3,000	20%
15,000 to 22,500	3,000 to 4,500	25%
22,500 to 37,500	4,500 to 7,500	35%
37,500 to 75,000	7,500 to 15,000	45%
75,000 to 150,000	15,000 to 30,000	55%
Excess over 150,000	Excess over 30,000	65%

^a See footnotes a and b re previous schedule.

(c) *The complementary tax on individuals.*—While this modern flat rate version of the old proportional tax is deemed to be only a temporary levy for the years 1959 and 1960, it may remain in force for a longer period. Though it reaches the majority of income items, salaries, wages, pensions, and the like are excluded. The rate is 9% for 1959, and 8% for 1960. Certain types of income enjoy a basic exemption of \$600 (3,000 new Francs) or \$880 (4,400 new Francs).

The impact of this tax is reduced by an arrangement which permits the amount of tax in one year to be deducted from the taxpayer's income of the following year in computing his *general* income tax.

(d) *Cumulative effect of complementary and progressive income tax on individuals.*—The cumulative effect of the two income taxes applicable to individuals can be best illustrated, as in Table I J, by the case of a married couple (neither of whom is on salary

or wages) who have one dependent child, their taxable income (appropriate deductions have been taken) being 37,500 N.F. (\$7,500).

TABLE I J

	<i>New Francs</i>	<i>Dollars</i>	<i>New Francs</i>	<i>Dollars</i>
<i>Taxable Income</i>	37,500	\$7,500		
1. The 8% complementary tax	<u>3,000</u>	<u>600</u>	3,000	\$600
2. Amount subject to general tax	34,500	6,900		
3. General tax Computation				
5% on 5,500 N.F.		275 N.F.		
15% on next 3,250 N.F.		487.50 N.F.		
20% on next 6,250 N.F.		1,250 N.F.		
25% on next 7,500 N.F.		1,875 N.F.		
35% on next 12,000 N.F.		4,200 N.F.		
	<u>34,500 N.F.</u>	<u>8,087.50</u>		
10% surcharge		<u>808.75</u>		
			<u>8,896.25</u>	<u>1,779</u>
4. Total tax (effective rate of about 32%) ^a			<u>11,896.25</u>	<u>\$2,379</u>

^a The effective rate of 32% relates to taxable income; because of certain standard deductions, it will actually be lower.

(e) *Corporation income tax*.—The French corporate income tax (Impôt sur les Sociétés) reaches the aggregate net income in a manner similar to that of the United States corporate tax. The two most notable distinctions between the two systems involves, first, the rate structure; France applies a *flat* 50%. Second, it reaches only income derived from French sources.

Another major distinction involves the treatment of dividends received by one corporation from another in which the former holds shares. In evaluating this arrangement, it must be remembered that the distributing corporation's own profits will be subject to the flat 50% corporate income tax. Then when it declares a dividend from that profit which is left after taxes, it must withhold a tax which represents an assessment against the recipient corporation, the amount normally being 24% of the gross dividend. Even so, the dividend is includible in the gross income of the recipient corporation for the purposes of computing its *regular* 50% corporate tax though at that point it enjoys a credit for the 24% previously

withheld. When the recipient corporation itself declares a dividend to its shareholders, it too must withhold a 24% tax. And those shareholders, if individuals, will also suffer the previously described income tax on individuals, the 24% withholding tax being treated as a credit.

In one circumstance, the multiple impact suffered under the regular corporate tax as a result of inter-company arrangements is largely eliminated. That circumstance involves the case where the recipient corporation is French and owns at least 20% of the share capital of the original distributing corporation.¹⁶ The recipient corporation will first receive a dividend-received deduction, much on the order of that allowed in the United States, in computing its own regular corporate tax. Limitation of the deduction to 75%, instead of allowing a full 100%, represents an attempt on a standard basis to accommodate the fact that a part of the recipient corporation's general expenses will have been attributable to dividends received. Secondly, while the 24% dividend tax must be withheld by the recipient corporation when it declares a dividend, this withholding principle is not applied to the extent its declaration is out of dividends which it earlier received from the original distributing corporation.

(f) *The French concept of gross income.*—With regard to business income derived by individuals or corporations, the concept of *gross* income is similar to that in vogue in the United States, the three prime differences being noted below.

The first difference relates to capital gains which are not taxed in France unless (a) they are regularly and professionally made by the taxpayer or (b) they involve business property. But even in the circumstance related in (b), the gain will not be recognized if it is reinvested within a specified period.

Where the gain is reached, ordinary rates are applied except where the gain is realized in connection with the termination of the business through liquidation or merger. In the latter event, lower rates are applied.

If a given capital gain would fall into the taxable category, the taxpayer may use a system of coefficients to upgrade the historical cost which would otherwise be used in computing his gain, the aim being to neutralize in some measure the effect of changes which have taken place over the years in the value of the franc. The schedule

¹⁶ Pursuant to the reform of 1959, the tax authorities may grant the same privilege to corporations which own less than 20% of the participating rights.

of coefficients with datelines representing possible points of purchase appears in Table I K.

TABLE I K

<i>Year</i>	<i>Coefficient *</i>	<i>Year</i>	<i>Coefficient *</i>
1914 and prior years	204.1	1937	36.1
1915	142.9	1938	31.9
1916	108.9	1939	30.7
1917	74.9	1940	24.6
1918	61.2	1941	22.5
1919	59.1	1942	20.4
1920	40.8	1943	14.9
1921	61.2	1944	13.7
1922	65.9	1945	6.8
1923	51	1946	4.3
1924	43.5	1947	3.4
1925	38.7	1948	1.9
1926	29.8	1949	1.6
1927	32.7	1950	1.4
1928	32.7	1951	1.05
1929	33.3	1952	1.05
1930	37.5	1953	1.10
1931	40.8	1954	1.15
1932	47.7	1955	1.15
1933	52.4	1956	1.10
1934	54.4	1957	1.05
1935	61.2	1958	1
1936	51		

(* Fixed by Decree No. 59-289 of 14th February, 1959.)

That portion of any gain which is immunized from the regular corporate income tax only because of the impact of the above coefficients, i.e., because of revaluations in the currency, must be reflected on a balance sheet as a special revaluation reserve and presently suffers a special 3% tax. The ordinary withholding tax applies, however, if that reserve is distributed, though in some cases the withholding rate is reduced to 12%.

A second major difference between French and United States concepts of gross income arises in the circumstance where a branch is shifted into a subsidiary. In France, one-half of any difference which exists between the book value and the current fair market value of the branch's assets is subjected to the ordinary corporate tax rates, provided the branch existed for less than 5 years. For older branches, only 10% of the gain is reached.¹⁷

¹⁷ The rate is only 6.6% in the case of private enterprises.

A third prime difference between the two systems with regard to the meaning of gross income involves private enterprises with relatively small turnover. In France, these may be taxed on the basis of a *presumptive* profit.

(g) *The French concept of "taxable" income.*—In a business setting, the deductions which may be taken from gross income under French law, in arriving at taxable income, are similar to those allowed in Belgium and the United States. In other words, the aim is to reach only net income and is accomplished through allowance of deductions for those expenses incurred in properly carrying on the enterprise, provided, of course, that the expenditure did not involve an increase in inventory or capital equipment. For example, interest on loans is deductible, even if paid by a subsidiary to a parent, provided the loan relates to the commercial aspects of the enterprise and the interest is fair and reasonable.¹⁸ Again, in principle the indirect taxes suffered by an enterprise are deductible in computing taxable income.

The annual French "amortization" (*amortissement*) deduction, designed to take account of normal wear and tear arising out of use of buildings, equipment, etc., differs in one major respect from the American depreciation allowance. Because of marked changes which have taken place in the actual value of the franc, France has found it necessary to make *standard* modifications in the historical cost against which depreciation would otherwise be computed. The procedure involves use of the coefficients previously described in connection with the discussion of capital gains. After applying the appropriate coefficient for the year of purchase to historical cost, previous depreciation—computed on the basis of historical cost for purposes of the current computation—is multiplied by the coefficients appropriate for the years of earlier write-offs. Following subtraction of the re-valued earlier depreciation from the re-valued historical cost, the normal rules regarding depreciation are applied, i.e., the balance is spread over the remaining useful life of the property. As in the States, determination of "useful life" ultimately depends on the way the taxpayer will use the property; extraordinary usage, for example, will be taken into account in making the determination. Certain general rate patterns have also been issued by the government to accommodate typical cases, and in some instances, for example with reference to hotels, quite detailed schedules have been promulgated. Until the recent tax reform, only the

¹⁸ However, interest paid to a parent or other shareholders is only deductible to the extent the loan does not exceed 50% of the subsidiary's capital.

straight line method was permitted, except in the instance where some additional depreciation was allowed to facilitate modernization of equipment. Now, however, the declining balance method may also be used with reference to a majority of investments.

Inventory is valued at cost or market whichever is less. It is not possible, however, to use the LIFO inventory method.

In the case of individuals, certain standard deductions may be taken in lieu of itemizing business expenses. The standardized figure for those working for salary or wages is 10% of the salary or wage; for commercial travelers, such as a salesman, the figure is 37%. In computing the *general* income tax, the taxpayer may also deduct his flat rate *complementary* tax, if any, and any versement forfaitaire which *he* may have suffered as an employer of domestics. Other items of an equally personal sort which are deductible include a limited amount of life insurance premiums on policies contracted before 1959, charitable contributions with a ceiling of .5% of taxable income, and alimony paid pursuant to the French civil law.

In addition to the foregoing deductions (including the standard business expense deduction), an abatement of 20% is allowed for salary and wage earners.

(h) *Payment and the taxable year.*—While the calendar year is usually the taxable year, an enterprise may elect a different fiscal year comprising not more than 12 months. However, losses of one year may generally be carried forward for a period up to 5 years.

While the tax due in one year relates to the income of the preceding fiscal year, in most cases a system of pre-payment exists.

Generally, a choice does not exist as to the matter of accounting methods. Special rules and regulations govern the matter of timing as it relates to different types of items, but in general the accrual basis constitutes the proper accounting method.

(i) *The relevance of residency as it affects individuals.*—As to *resident-individuals*, France asserts a less sweeping jurisdiction in assessing its flat rate complementary tax than it does with reference to the general income tax. Applicability of the former tax rests, in general, on a principle of territoriality, the tax applying only to that part of a resident's income which has its source in France. The only major exceptions relate to dividends and interest which, absent treaty provisions, are included regardless of source.

The general income tax, on the other hand, quite generally reaches all of a resident's income, without regard to source. A combination of these divergent general jurisdictional principles means, except for dividends and interest, that the foreign "sourced" income of residents suffers a smaller total tax than does domestic income.¹⁹

Nonresidents enjoy an even more favorable status. Since they suffer either tax only with reference to income which has its source in France, the residency of an individual under French law may assume considerable importance. Normally a foreigner residing in France will not be treated as a resident unless he has transferred his sphere of interest to France or remains there for at least 5 years. Until one or the other of these tests is satisfied, the foreigner will suffer tax only on his French income, though in the absence of such he will be taxed on an amount five times the rental value of his dwelling. When one of the alternative tests for residency is finally satisfied, the foreigner may still be immune from the general income tax with reference to *non-French* income if he is able to demonstrate that he is properly taxed on such by the country of which he is a citizen.

(j) *The relevance of residency as it affects corporations.*

—In general, the corporate tax follows the principle of territoriality with reference to domestic as well as foreign corporations. Thus both are taxable generally only on profits deemed to have a source in France. In the case of a foreign corporation, this includes income arising from a complete cycle of economic transactions in France as well as those earned there by a foreign-owned permanent establishment.²⁰

Since even a French corporation will suffer the regular corporate tax on its *foreign* income in only rare circumstances, the most important difference between French and foreign corporations relates to the separate 24% tax which it must withhold as a charge against stockholders on gross dividends. The French corporation must withhold this tax without regard to the geographical source from which it derived the income from which the dividend was paid. The non-French corporation, on the other hand, must withhold the 24% tax only on that part of the dividend which corresponds to its French business.

¹⁹ Accordingly, there is less pressure in France for unilateral tax relief in the case of foreign income than would otherwise be the case.

²⁰ Pursuant to a bilateral tax treaty with the United States, the industrial and commercial profits earned by an American corporation will be taxed in France only if it has a "permanent establishment" there.

Section B of PART III, *infra*, indicates two modifications of the foregoing pattern as it affects American residents and entities. First, the withheld dividend tax, payable illustratively on dividends distributed by a French subsidiary to an American parent, is reduced by a bilateral tax treaty to 15%. Second, while the French subsidiary will also have previously paid its own 50% corporate tax, the latter is the *only* income tax suffered if an American company conducts its affairs in France through a permanent establishment in the nature of a branch located there. In that event, the base would consist of income properly attributable to the permanent establishment, as is more fully explained in PART III, *infra*.

(k) *The comparative cost of retaining and distributing corporate profits.*—In Belgium, it will be recalled, distributed profits encountered a different *corporate* tax pattern than undistributed profits. This is not so in France. Distributed and undistributed profits are taxed alike. France does not even employ the type of additional penalty tax which may be encountered in America with regard to unreasonable accumulations. In this connection, a flat *unavoidable* temporary levy of 2% on reserves—an outgrowth of the extraordinary expenses incurred in Algeria—was terminated at the close of 1958.

While the corporate tax itself remains the same, whether or not profits are distributed, it must be remembered that the corporation, upon distribution, will be required to withhold, as a charge against stockholders, the 24% tax on dividends, a figure which is reduced to 15% in the case of payments to American residents or corporations.

A French corporation which decides to retain certain earnings may capitalize them, without prejudice to the stockholders, by distributing a stock dividend. Only if the recipient stockholder later receives a liquidating dividend will his earlier receipt of the stock dividend have any tax significance to him. For tax purposes, the nominal (par) value of his original shares will have been spread in proper proportion to include also the dividend shares. Illustratively, if his original shares carried a par value of \$100, receipt of a 100% stock dividend would lead, for tax purposes, to a new allocation of a \$50 par value to each of his original and dividend shares. And only that amount could be recaptured tax free at the point of liquidation.

(l) *Disposition of an incorporated enterprise.*—If a corporation sells its assets as a preliminary step to liquidation, that part

of the gain, if any, attributable to capital assets will be taxed at the special rates previously indicated, i.e., at 10% on gain from any such assets held for over 5 years and at 50% on one-half of the gain realized from any such assets held for a lesser period. Then on distributing the after-tax balance, the corporation must withhold the 24% dividend tax.

A merger out of which stockholders derive new shares of stock is not treated as a liquidation; gains which would have otherwise been taxed on liquidation enjoy an immunity in the case of merger, the distinction resting on the fact that here there is a continuity of interest on the part of all concerned. The constituent corporation which is absorbed in the merger will, however, file a separate corporate tax return covering the ordinary profits of the partial year concluded by the merger.

SUBSECTION 2. OTHER FRENCH TAXES

(a) *Taxes on capital and property.*—France does not impose taxes on capital or property simply because of its ownership. However, fairly significant amounts may be exacted when property is transferred. If the transfer is for money or money's worth and the deed must be registered, a registration duty must be paid. This registration fee, upon the sale of real property, is apart from a low tax and must be paid at the rate of 16.6%. However, the rate is only 2.2% when real property is brought into a corporation. On the establishment of a corporation a different fee of 1.6% is levied on the share capital.

(b) *French turnover taxes.*—An unusual type of turnover tax is actually more important to the French government than the income tax. The former tax differs markedly from the turnover taxes of other member nations. Most countries impose a tax on each transfer, measured by the delivery price. As a consequence, an integrated company may have a real advantage over a non-integrated company. In France, however, the net effect is to tax only that value which each successive entrepreneur adds to the product, thus depriving integrated companies of the advantage they enjoy in other countries. While the French tax base is smaller than that of other countries, it will also later be noted that the rate in France is somewhat higher.

In effect, the technique by which only the added value is reached involves two separate steps. First, the full effective rate is applied against each vendor on the delivery of goods, the amount of the tax being separately reflected by him on the invoice which is delivered

to the buyer. Before paying the tax, as a second step, the vendor deducts the amount of turnover taxes reflected on invoices which he received covering his purchase of components, services, and equipment (including such things as machinery and industrial buildings). The practical effect, if the rates are always the same,²¹ is that the manufacturer, e.g., will usually pay a tax on the difference between his selling price and the lesser sum which he paid for raw materials, etc.

The turnover tax is also applied at the point goods are imported. However, at the point of export, any tax paid at import or with respect to intermediate domestic transfers is wholly refunded.

The normal French rate is stated to be 20%, but since the base against which it is applied includes the tax itself, the normal *effective* rate which is reflected on an invoice is 25%. Transfers of certain types of goods call for special rates, some higher and some lower than the normal rate. The stated rate for services is 8.5%,²² the effective rate being 9.23%.

While these rates are higher than those of most member nations, thus neutralizing in one degree or another the use by the French of a smaller base, account must also be taken of two other considerations in reckoning the total impact of its turnover taxes. One of these involves the immunity of the retailer's mark-up from this tax. In other words, retail vendors—normally the last in a chain of successive vendors—are exempt from the added value turnover tax. Indeed, in some significant circumstances, wholesalers are also exempt. However, the exemption of retailers is itself in part neutralized by *local* turnover taxes levied on the *entire* retail sales price at a stated rate of 2.75%, the effective rate being 2.83%. The difference between the tax load borne by retailers and that borne by others is not as great as one might suppose. The tax on the retailer covers the *entire* price, not just the value added. In other words, he is not permitted to deduct earlier turnover taxes paid by those from whom he acquired his merchandise.

(c) *Miscellaneous taxes.*—French business is subject to a number of taxes in addition to income, conveyancing, and turnover taxes. One involves the previously described “versement forfaitaire” which is assessed against employers with respect to salaries and wages paid employees. Another is closely akin to a

²¹ The rate will not always be the same, particularly with reference to services.

²² This same rate normally applies to royalties. However, under certain bilateral tax treaties, including one with the United States, royalties derived by nonresident *inventors* are usually exempt. See PART II, *infra*.

business license tax (contribution des patentes), the amount being dependent upon four factors: (a) the scale of the business; (b) the location or municipality in which the business is located; (c) the rental value; and (d) the number of employees.

Special duties are also levied on certain types of consumers' goods, such as wine, meat, coffee, and tea. On the other hand, controlled monopolies have taken over the sale of certain other products, such as tobacco, explosives, and matches.

Motor vehicles are also subject to a special tax, one which differs from that levied on freight carriers. The latter also enjoy freedom from the turnover tax.

SECTION C. FEDERAL REPUBLIC OF GERMANY

SUBSECTION I. INCOME AND NET WEALTH TAXES

(a) *In general.*—The basic pattern of income taxation in Germany, as it affects individuals, differs substantially from the previously described Belgian system. Whereas the latter country generally exacts two different income taxes from individuals, Germany imposes only one ²³ (Einkommensteuer), with progression in the rate structure rising to a ceiling of 53%. A limited exception to this unified arrangement involves a separate substitute withholding tax on income from certain kinds of bonds. Though that substitute exaction may be a *final* levy, under certain conditions a taxpayer is permitted to aggregate this type of bond income with other types of income in computing the more general income tax, the amount previously withheld being treated in such case as a credit. Other withholding taxes, such as those on wages and dividends, are generally treated as integral parts of, and serve as credits against, the general income tax.

Germany's corporate income tax differs from the previously described counterpart found in France. It will be recalled that the latter does not discriminate at the corporate level between distributed and undistributed earnings; its flat rate tax is imposed uniformly, for the year income is earned, without regard to dividend policy. Germany, like Belgium, does discriminate at the corporate level. While the former imposes only one corporate income tax, the rate on distributed profits is much lower than the rate on those corporate profits which are not currently deflected to stockholders.

²³ The important churches are permitted to levy a church tax as a surcharge on the income tax, but in an amount not exceeding 8% of the income tax.

However, as later explained, the impact of this differential on certain smaller corporations which must look to internal financing for expansion has been whittled down through application of a special rate structure. In either case, however, distributed profits will suffer another tax in the hands of shareholders, as in Belgium and France.

Corporations as well as individuals are also subject to a flat rate tax on net wealth (*Vermögensteuer*) though only individuals may deduct this tax in computing the general income tax base. In addition, enterprises, whether owned by a corporation or individuals, suffer a municipal enterprise tax (*Gewerbesteuer*), which uses income as one of the factors in fixing the amount of the exaction. The amount of this tax constitutes a deduction for both individuals and corporations in determining that income subject to the general income tax.

(b) Income, enterprise, and net wealth taxes on individuals.

—The income tax on individuals caters to married persons and, up to a point, progressively also to those with children.

The split-income system which is normally utilized by married persons in the United States is also available in Germany. The tax on a married couple is twice the amount which would otherwise be due on one-half of the combined income of the two spouses. Where the two spouses earn different amounts, the effect is to spread their incomes equally between the two, confining the income to lower rate brackets.

Taxpayers who file a separate return enjoy a personal allowance of \$400 (DM 1,680); husbands and wives who file a joint return have two such allowances. There is also a modest allowance for old age; single taxpayers over 50 years of age may deduct \$200 (DM 840) from gross income; those over 70 enjoy an additional allowance of \$85 (DM 360), this amount being doubled in the case of married persons.

Allowances for children, accommodated through deductions from gross income, are progressive in amount up through the third child, at which point they level off—as follows:

	<i>Dollars</i>	<i>DM</i>
First child	\$215.	900.
Second child	400.	1,680.
Third child, and each added child	429.	1,810.

The significance of the personal allowances and the right of married persons to split their incomes on filing a joint return can

be illustrated by the case of a male taxpayer whose total earned income, all being derived from employment, is \$9,524 (DM 40,000). As a single person, he would pay \$3,060 (DM 12,843), the effective rate being 32% compared with an effective rate of 25% if, as a married taxpayer, he filed a joint return, and with 22% for married taxpayers with two dependent children. Those who reside in Berlin would also enjoy a 20% tax reduction.

Individuals also suffer a flat 1% deductible tax on net wealth. This means that a taxpayer whose income is derived from a stock portfolio will suffer larger cumulative taxes than will a taxpayer who does not own property but derives from employment a like amount of income. The difference can be illustrated by the previously mentioned single taxpayer whose total net income equalled \$9,524 (DM 40,000). Whereas his effective rate was 32% when all of such income was derived from employment and subject only to the income tax, the cumulative effective rate of both taxes would be 39% if one-half of his income had been derived from stocks valued at \$119,047 (DM 500,000).

The net wealth tax, like the general income tax, applies whether the individual is a property-owning employee or is engaged in the operation of a business. However, the businessman also incurs a three-factor municipal enterprise or trading tax, the rates of which vary among municipalities. The basic rate is progressive up to 5% on profits and is .2% on net worth and wages. Surcharges with respect to profits and net worth reach a maximum of twice the basic charge, increasing the tax to 15% on profits and .6% on property. Surcharges with respect to the tax on wages may, on the other hand, increase that basic levy tenfold. This three-factor tax is deductible, however, in computing taxable income for purposes of the general income tax, and may be treated as a debt in calculating the net amount of property owned. *Inter alia*, the foregoing principle means that the trade tax which is paid is deductible in computing that portion of the trade tax which turns on profit, for that net income which is used in computing the general income tax is also the income which is used in computing the trade or enterprise tax.

(c) *Income, net wealth, and enterprise taxes on juridical entities.*—The corporate income tax (C.I.T. Körperschaftsteuer) reaches the aggregate net income of all juridical entities (*Aktiengesellschaft, Gesellschaft mit beschränkter Haftung, etc.*), the prime rate being a flat 51%. However, this is reduced to 15% with respect to that portion of the income which is currently distrib-

uted.²⁴ Except in one instance, however, distributed profits are further subject to a 25% withholding tax against stockholders who apply it as a credit against their own general income tax.²⁵ The one exception is intended to avoid multiplication of the tax load in the case of certain inter-corporate dividends. If the distributee is another German corporation which has shares outstanding and which owns 25% or more of the stock interest of the distributing corporation, the latter is not required to withhold the dividend tax. Nor will the recipient corporation be required to include the dividend in its own gross income, provided that dividend is immediately distributed to its own stockholders. In such case, it will, however, withhold the 25% dividend tax. Moreover, if it retains the dividend, it must pay a special tax of 36% (51% less 15%). This special levy was designed to prevent avoidance of the 51% rate where profits of a subsidiary are not effectively distributed to the ultimate equity owners, i.e., stockholders of the parent. Absent this special arrangement, it was thought that subsidiaries might avoid the 51% tax by distributing dividends to a parent which, instead of distributing the profit to its own shareholders, might then loan the funds back to the subsidiary.

Because of the marked differential between the normal corporate rates on distributed and undistributed profits, a special cushion has been designed to facilitate internal financing by small corporations which have a net worth not exceeding \$1,185,000 (DM 5,000,000), provided their shares are in registered form and are owned, to the extent of 76% or more, by individuals. In such case, a progressive rate—the maximum charge being 49% on a profit of \$11,850 (DM 50,000), is applied to the undistributed profit. But the tax on distributed profits of such a corporation is 26.5% instead of the normal 15%.

Juridical entities also pay the flat 1% tax on net wealth as well as the special municipal enterprise tax on their profits and net wealth. The basic rates and surcharges of the latter are similar to those described above in the setting of individuals. Also, as in the case of individuals, there is a 20% rate reduction in taxes for enterprises in West Berlin.

(d) *Combined impact of corporate and individual direct taxes.*—In calculating the cumulative effect of direct taxes imposed,

²⁴ The 15% rate is applied to the so-called "berücksichtigungsfähige Ausschüttungen." Literally translated, this means "distributions that may be taken into account." In effect, the low rate will apply only to those distributions which are made pursuant to a resolution adopted at a shareholders' meeting.

²⁵ Applicable only to distributions by German corporations.

for example, on a manufacturing corporation and its stockholders, account must always be taken of three taxes on the corporation (general income tax, trade or enterprise tax, and net wealth tax) and, if any profits are distributed, of two taxes on the individual stockholders (income and net wealth taxes). It does not follow, however, that a constant percentage of corporate profits will always be absorbed by these five taxes. Because the normal corporate rate of 51% differs from the reduced 15% corporate rate on those profits actually distributed, there will be differences in the total tax load depending on whether all, part, or none of the corporate profits, after taxes, are distributed. Moreover, if it is contemplated that all of the profits, after taxes, of various corporations will be currently distributed, there will still be differences in the degree to which those profits are absorbed by direct taxes. In the first place, the ratio between corporate net wealth taxes and corporate profits will not be the same for all industries. Nor, with reference to the net wealth tax on stockholders, will the ratio between stock values and dividends be constant. Again, the ratio of the corporate trade or enterprise tax to corporate profits will vary among municipalities because of differences in rates applied to the three base factors; variation with reference to this tax will also exist among corporations within a municipality because of differences in ratio between two of the contributing factors (net wealth and wages) and corporate profits. Finally, with reference to the general income tax itself, there is a difference in the rate structure for those small corporations which pay 26.5% on distributed profits and others which pay 15%, just as there are differences in the progressive rate applicable to stockholders who enjoy varying amounts of income.

Only if one indulges in certain assumptions is it possible even to measure the cumulative effect of the 3 direct corporate taxes. For example, if it be assumed (1) that all corporate profits (after corporate taxes) are currently to be distributed, (2) that the corporation's profits before taxes bear a 10% ratio to its net wealth which, in turn, is subject to the non-deductible net wealth tax, (3) that the normal corporate income tax rate structure (51% with a reduced rate of 15% on distributed profits) is to be applied, and (4) that the municipal trade tax is levied at more or less maximum rates on profits and net wealth (15% and .6% respectively), it is possible, through application of a complicated formula, to predict that direct corporate taxes will absorb 53.04% of the company's profits, leaving 46.96% of such profits for distribution. In the foregoing circumstance, of the total corporate tax of 53%, approxi-

mately 18.2% is attributable to the municipal enterprise tax, 10% to the net wealth tax, and 24.8% to the corporate income tax. That the corporate income tax absorbed almost 25% of the profits, as computed before taxes, may come as something of a surprise in view of the assumption that all profits, after taxes, were distributed and that one rate on distributed profits was only 15%. However, the latter rate is applicable only to that portion of corporate profits actually deflected to stockholders; in effect the 51% rate is applied to that portion of the profits absorbed by the tax collector.

Using the same assumptions, except that now 40% of the profits *after* direct taxes will be distributed, the tax collector would absorb through direct corporate taxes almost 65% of the corporate profits as contrasted with almost 70% if *none* of the profits were to be distributed.

The minimum separate impact of a distribution on stockholders can be illustrated by returning to the case where *all* of the after-tax corporate profits (47% of pre-tax profits) were distributed. If the stock yields only 4% on its value, the 1% tax on the shareholder's net wealth will absorb 25% of the dividend. And if it be further assumed that the taxpayer is single, and that he derives all of his modest income ²⁶ (\$2,380 or DM 10,000) from dividends, his personal exemption and deductions will convert the first bracket income tax rate of 20% into an effective rate of 10.74% of the dividend. Thus in this case, corporate and individual direct taxes would have the following cumulative effect:

Corporate profits	\$100.
Less corporate taxes	<u>53.</u>
Dividend	\$ 47.
Less individual direct taxes:	
Net Wealth Tax	
— 25% × 47% = 11.75	
Income Tax	
— 10.74% × 47 = 5.05	
Church Tax	
— 8% × 5.05 = .40	<u>17.20</u>
% of Corporate profits after all direct taxes	<u>\$ 29.80.</u>

(e) *German concept of gross income.*—As a general proposition, the gross income of an individual includes all of his profits, with certain exceptions the most important of which relates to

²⁶ The standard deduction for expenses has been taken into account (DM 150). The property tax is deductible as a personal expenditure.

capital gains. While these are generally excludable, the immunity does not extend to three frequently recurring situations. Profits derived from sales of property used in an enterprise, such as office equipment or obsolete machinery but not land, is considered a business profit and must be included. Speculative gains, if they equal \$238 (DM 1,000) or more a year, are also includible. A gain is deemed speculative if it is realized from the sale of immovables held for less than 2 years or from movables held less than three²⁷ months. Finally, profit in excess of a certain amount, derived from the sale of certain corporate shares, will be taxed, though at special rates, even though such shares do not constitute a part of the normal trading assets of the taxpayer. This principle is applied in the instance where the taxpayer actually or constructively owned a "considerable interest" in the corporation. The taxpayer will be treated as though he owned such an interest if, immediately before the sale or within the 5 preceding years, he, his wife, fiancée, or certain relatives owned more than 25% of the nominal paid in capital. The special rates are fixed by the tax authorities and range from 10% to 30%. Usually a rate equal to one-half of the rate applied to the taxpayer's total income will be used. While profits of this type are taxed only if they exceed a certain amount, that minimum standard varies and depends on the portion of the enterprise's capital which is sold.

With one prime exception, all profits realized by a corporation are taxable, including capital gains. The one exception relates to the previously discussed immunity extended to inter-corporate dividends where a recipient German corporation holds at least 25% of the shares in a distributing German corporation. However, as previously noted, the recipient corporation will be required to pay a 36% tax if it does not make a current distribution of the dividend to its own shareholders. A corporation may also transfer a branch to a subsidiary without recognition of gain, if any, provided the subsidiary continues to reflect the assets at the value at which they were carried on the parent's balance sheet.²⁸

With certain modifications, the income factor of the municipal enterprise tax is also calculated according to the profits concept of the general income tax. The modifications relate to deductions as well as inclusions. For example, interest paid on long-term debts

²⁷ A tax reform bill will extend this period to six months.

²⁸ Whether this applies to a *foreign* corporation with a German branch has not been settled. The statute is not wholly clear on this point, and there are no interpretative decisions.

and salaries paid to shareholder-managers who own a significant interest (25% or more) must be restored to income. On the other hand, income from foreign permanent establishments may be excluded. In keeping with the philosophy of the first of the foregoing modifications, involving restoration to income of interest paid on long-term debt, it should also be noted that the long-term debt itself is treated as a part of the company's net worth for purposes of the separate net wealth factor.

(f) *German concept of "taxable" income.*—In the case of an individual, deductions from gross income include personal as well as business expenses.

Personal or non-business expenses (*Sonderausgaben*) which may be itemized, apart from the previously described basic exemptions allowed for the taxpayer and his dependents, are of three types. First, the entire net wealth and church taxes paid by an individual, as well as interest on personal loans, may be deducted. Second, up to a certain maximum amount, deductions may be taken for premiums for social security as well as life, health, and accident insurance, and subject to a separate maximum limitation—amounts contributed to charity and the like. In lieu of itemizing these first two types of personal expenses, the taxpayer may take a standard personal deduction. If his total income is derived wholly or partly from employment or consists of periodic payments, the standard minimum is \$150 (DM 636); in other cases it is \$48 (DM 200).

Finally, so-called extraordinary charges associated with illness, death, etc., are separately deductible to the extent they exceed a minimum amount. Even extra expenses for a housekeeper may be fitted into this category under certain conditions. The minimum amount which a taxpayer must absorb without benefit of a deduction varies, depending upon the taxpayer's income and family status.

Itemization of an individual's business expenses can also be avoided by his election to take certain standard business deductions. For wage and salary earners, a minimum amount of \$135 (DM 564) is allowed. With respect to income from capital, the standard deduction is \$35 (DM 150) or twice that amount for a married couple, and for periodic payments the standard is \$48 (DM 200).

The categories of business expenses which may be itemized are quite similar to those in the United States, and include wages, salaries (but not remuneration paid directors²⁹), rents, depreci-

²⁹ In German law, the term, "directors," may refer to "Vorstandsmitglieder" (managing directors) or to "Aufsichtsratsmitglieder" (members of the board of directors). Only the latter group is meant here.

ation, interest (including reasonable interest charges paid to a parent company or other shareholder), excise duties, turnover taxes, and the enterprise tax. The net wealth tax is deductible, however, only by *individuals* and as a personal item; it is *not* deductible by corporations.

Enterprises may compute depreciation by straight-line, accelerated, or other methods, depending on which is the more suitable, but subject to certain legal limitations. Beginning with 1958, a deduction under the accelerated method cannot exceed 25%³⁰ of the base nor can it be more than 250% of that which would be allowed under the straight-line method. Perhaps because of its rapidly expanding economy, Germany does not presently complement its regular depreciation allowances with additional first-year incentive allowances.

Inventory valuation must generally conform to the so-called "Niederstwertprinzip," i.e., cost or market whichever is lower. Although it was thought that the law permitted taxpayers to reflect inventory at cost even though the replacement market price was lower, court decisions have reached a contrary result. In any event, generally speaking, valuation of assets for tax purposes must conform to those valuations reflected on balance sheets for commercial purposes.

Also with reference to the matter of inventory, the Supreme Tax Court has determined that the taxing statute does not permit the use of LIFO or the base stock method. This limitation may not be particularly important in the German setting, for there has been little inflation in recent years. Nevertheless Section 51 of the taxing statute authorizes the Minister of Finance to promulgate regulations, with the approval of Parliament, allowing the creation of replacement reserves. Such a reserve is authorized only where there has been a price increase of 10% or more in the taxpayer's replacement market during the year. Moreover, within a period of six years the reserve must be restored to profit.

(g) *Payment and the taxable year.*—The tax must generally be computed by reference to a period of 12 months, and most taxpayers use the calendar year. However, in order to accommodate cases of fluctuating income, commercial losses of one year may be carried forward, if need be, into each of the 5 succeeding taxable years—offsetting the income of those years. Carrybacks are not permitted.

³⁰ A tax reform bill will limit this to 20%.

Most businesses are required to reflect their incomes according to an accrual method of accounting.

Much of one's tax is paid currently, either through withholding or quarterly estimated payments. In general there are two types of withholding. The first relates to the 30% withholding rate (Kapitalertragsteuer) applied to interest on certain bonds, a levy not ordinarily applied to nonresidents. The taxpayer may elect to treat the amount withheld here as a *final* payment, in which case the interest itself is excluded from his aggregate income in applying the progressive rates of the general income tax. The other withholding taxes on income, such as that applicable to wages (Lohnsteuer) or to income derived from other forms of capital (Kapitalertragsteuer) are thought of as integral parts of the general income tax itself, serving as credits. This is particularly important with reference to the withholding tax on dividends, for a flat 25% is withheld. In the case of nonresidents, however, this latter figure is usually the final levy.

While the withheld wage tax is generally treated as a credit, in one instance it too may constitute the final levy.³¹ This will be so where the taxpayer (1) derives compensation (or a pension) from only one employment, (2) the amount is not in excess of \$5,700 (DM 24,000), and (3) his income from sources other than employment does not exceed \$190 (DM 800).

A special director's tax (Aufsichtsratssteuer), applicable only to *nonresident* members of a company's board of control, is also handled on a withholding basis. Resident directors, however, handle their fees under the general income tax; indeed, such fees are not even subject to the general withholding tax on wages.

(h) *The relevance of residency.*—The tax base of a *resident* of Germany includes income derived from without as well as that derived from within the country, without regard to his nationality. However, a unilateral provision, much like an arrangement in force in the United States, serves to avoid double taxation. Foreign income taxes paid on amounts derived from without Germany may be taken as a credit against the German tax.

Nonresidents are subject to taxation only with reference to income derived from German sources. Aside from this jurisdictional limitation, the principles which govern the calculation of a resident's gross income generally apply to a nonresident. A variation

³¹ However, there may be adjustments at the end of the year. The arrangement is called Lohnsteuerjahresausgleich, for it involves annual averaging of the wage tax.

exists, however, with respect to one of the three exceptional cases where capital gains suffer tax incidence. In the case of a nonresident, so-called speculative capital gains are taxed only where derived from the sale of land.

Except in two primary instances, a minimum 25% tax rate applies to nonresidents. This minimum is not applicable to wage earners who are taxed by reference to the normal tables. Also, in lieu of the regular minimum, nonresident corporate directors pay a flat 30% tax on their remuneration as a final levy.

(i) *The comparative costs of retaining and distributing corporate profits.*—Sub-topic (a), *supra*, points up the difference which exists in the rates applied to distributed as distinguished from undistributed profits. In effect, this difference (15% on distributed profits compared with 51% on undistributed profits) constitutes a penalty tax on the use of undistributed profits for purposes of expansion.

There is only a slight variation on the foregoing theme in the instance where a German facility is owned directly or indirectly by an American corporation. If the facility is operated as a branch, a progressive rate, ranging up to 49%, is applied without regard to whether the profits are transferred to the United States. If all of the profits are to be distributed, it may be less expensive, tax-wise, to operate through a subsidiary. In that event the subsidiary will pay at the 15% rate (as distinguished from the 51% if the profits are retained) and will withhold a dividend tax which is limited by a tax treaty to 15%.³² These two levies will not, however, represent exactly 30% of the subsidiary's profits. In the first place, that portion of the subsidiary's profits which is absorbed by the corporate levy will be taxed at the rate of 51%, for to that extent the profit is not actually distributed to stockholders. Secondly, the 15% dividend tax is applied, not to the subsidiary's total profit, but only to that part (subsidiary's profit *after* taxes) of the profit actually distributed to stockholders. There is one other basic tax difference between operation through a branch and through a subsidiary. Even if a branch could be financed through loans from the American parent, any so-called interest would not be deductible by the branch. A subsidiary, however, may obtain such a deduction in computing its taxable income for income tax purposes, but not for purposes of the municipal enterprise tax.

³² A change in the existing Germany-U.S. treaty is being negotiated, the German aim being to restore the withholding tax on intercorporate dividends to 25%.

(j) *Disposition of an enterprise.*—Where a corporation disposes of its business, the income tax will be applied to the difference between the adjusted basis and the selling price of the assets. And upon liquidation of the corporation a shareholder will suffer a tax on his realized gain if he has a significant interest (25% or more) in the corporation or, in the case of residents, if his gain fits into the so-called speculative category (holding period 3 months or less).

While the foregoing suggests that a disposition of an enterprise is generally a tax reckoning event, under certain conditions it is possible to effect a merger of corporate enterprises without immediate income tax cost but in effect, of course, tax incidence is only postponed until a later tax reckoning event—such as a liquidation.

SUBSECTION 2. OTHER GERMAN TAXES

(a) *German taxes on capital and property.*—In the case of resident corporations and individuals, the previously described net wealth or property tax (*Vermögensteuer*) is applied to property wherever situated. Nonresidents are reached only with respect to property situated within Germany. While the rate is normally 1%, a minimum base of \$23,810 (DM 100,000) is assumed for a corporation and \$4,762 (DM 20,000) is assumed for a private company (*Gesellschaft mit beschränkter Haftung*). All enterprises also pay the previously described enterprise or trade tax. There is also a very modest land tax (*Grundsteuer*) running from .5% to 1% of the rental value of the property. To this, surcharges may be added.

A registration duty (*Grunderwerbsteuer*) is also payable upon the transfer of real estate for money's worth—the normal rate being 7%. While this registration duty is avoided in the case of a gift, such a transfer will be subject to a gift tax which is integrated with the German death duty (*Erbschaftsteuer*)—common principles being applicable to *inter vivos* and testamentary transfers. The rate is progressive, running up to 60% on gifts in excess of \$2,380,000 (DM 10,000,000) where the donor and donee are strangers.

(b) *Turnover taxes and excise duties.*—Revenue from the German income tax is supplemented substantially by a multiple stage turnover tax which is applied to the rendition of services as well as to each transfer of goods in the course of developing a finished product. While every turnover is taxed, the normal rate of 4% is reduced to 1% in the instance where one entrepreneur transfers an item to another entrepreneur without changing its nature.

Laying aside the matter of tariffs, imports might be said to enjoy a tax advantage, for a flat 4% tax is applied at the point of importation regardless of the number of stages through which the imported product may have previously gone.³³ In certain cases, however, this rate may be increased up to a ceiling of 6%.

Export transactions enjoy even more favorable treatment. In order to make German products more competitive in the world market, these have been exempt. In fact, at the point of exportation, refund may be obtained—according to certain *fixed* standards—of any turnover taxes paid on *prior* transfers. The formula which governs such refunds is not, however, always generally thought to be sufficiently generous to accommodate the entire actual amount of turnover taxes previously paid.

While the turnover tax rate for luxury goods is the same as for other goods, special excise duties do exist with reference to a number of products, e.g., tea, beer, coffee, sugar, tobacco, playing cards, etc. On the other hand, some products, such as bread, are immune from the turnover tax.

(c) *Registration duty on capital contributions.*—When new capital is contributed to a corporation or is devoted to a branch of a foreign corporation, a registration duty (*Gesellschaftsteuer*) of 2.5% must be paid. On issuance of bonds, a similar 2.5% levy (*Wertpapiersteuer*) is imposed.

(d) *Miscellaneous.*—Other taxes utilized by Germany include those on motor vehicles (differentials frequently being geared to cylinder volume or weight) and testamentary transfers. The latter is geared to a progressive rate schedule which looks to the value transferred as well as the character of the relationship between the decedent and the beneficiary. It applies if a resident-beneficiary receives property from a nonresident as well as where the decedent was a resident. If neither party is a resident, it applies if the property is situated in Germany.

SECTION D. ITALY

SUBSECTION I. INCOME TAXES

(a) *In general.*—The Italian income tax system is quite similar to that of Belgium in that it consists of a series of different income taxes. Income of individuals and juridical entities is first divided by reference to its type into four prime categories, each of

³³ This matter, as it relates to exports from the United States to Germany, is more fully covered in PART II, *infra*.

which is subjected to a different tax rate. The four separately scheduled assessments relate, respectively, to (1) estimated income from rural property, (2) income from the active conduct of an agriculture or farm enterprise, (3) estimated income from urban property, and (4) income from labor, from movable capital (including interest but not dividends), and from industrial and commercial activity.

Superimposed on these separately scheduled assessments is a fifth tax, applicable only to individuals, covering *aggregate* income. A sixth tax, applicable only to corporations, is more closely akin to an excess profits and property tax than to an income tax.

On behalf of municipalities, a family tax is also imposed on the aggregate income of all members of a family. Municipalities, provinces, Chambers of Commerce, and certain others may also levy surcharges on other taxes, and these will differ from place to place.

A more detailed analysis of the cumulative effect of these various taxes follows.

(b) *Separately scheduled taxes on income from rural property.*—The first separately scheduled tax relating to rural property (*Imposta sui Terreini*) is applied to *imputed* income, determined by reference to values reflected in a land register, rather than to actual income. Because the base itself is quite unrealistic, the land register not having been brought up to date after a substantial monetary devaluation, the rate applied to the base is very high. The basic rate of 10% is multiplied by a coefficient of 12; surcharges by various units may increase the resulting rate to 1467% of imputed (not actual) income.

Assuming the owner does not use the property in the active conduct of farming or, alternatively, in industrial or commercial operations, his actual income from the property, as distinguished from the imputed income, will not be assessed under any of the other separately scheduled assessments, though it will be subject to the complementary personal tax on *aggregate* income or to the corporate excess profits tax, as the case may be. On the other hand, if the owner uses the property in connection with industrial or commercial activities, the imputed income is not subject to the first separately scheduled assessment but the actual amount will be subject to the fourth separately scheduled tax on industrial and commercial activity, as described below in sub-topic (d).

A second and quite distinct tax on rural property actually relates

to income from the active conduct of farming operations (*Imposta sul Reddito Agrario*). While the basic rate is 10% multiplied by a coefficient of 12, surcharges by various units may increase the total to 300% of imputed (not actual) income. If the land is rented instead of being actively used by the owner, neither party will pay this tax. The owner will pay the previously described tax on imputed income from rural property not actively used by him, and the lessee will pay the fourth separately scheduled assessment on income from industrial and commercial activity, described—as noted above—in subtopic (d) below.

(c) *Separately scheduled tax on income from urban property.*—The separately scheduled tax relating to urban property (*Imposta sui Fabbricati*) is applied to the actual income therefrom, though imputed income is sometimes used as an audit yardstick. Surcharges added to a basic rate of 5% can run the total to as high as 31% of the actual income.

This tax does not apply to income from urban property occupied by an enterprise engaged in industrial activity, the building being used to house machinery and the like. In that circumstance, but only that circumstance, the income will be reached by the fourth separately scheduled tax relating to industrial activity. In all cases, however, the complementary personal tax on aggregate income or the corporate excess profits tax will be applied.

(d) *Separately scheduled tax on income from certain capital, labor, and industrial or commercial activity.*—The separately scheduled tax on income from capital and/or labor (*Imposta sui Redditi di Ricchezza Mobile*), generally known as R.M., is further divided into four basic classes.

Class A includes only that income which is derived from capital, i.e., interest³⁴ and the like, but excluding dividends. Surcharges increase the basic rate of 23% to 26.32%.

Class B includes income from a combination of capital and labor, usually relating to commercial and industrial profits. In the case of individuals and partnerships, the first \$387 (240,000 Lire) of this income is exempt; from \$387 to \$1548 (960,000 Lire), the federal rate is 9%; on income from \$1548 to \$6840 an 18% rate is applied; any excess over \$6840 suffers a 20% rate. A flat rate of 18% is applied to the first \$6840 realized by corporations; any excess is subject to a 20% rate. However, both corporations and

³⁴ The 26.32% rate is temporarily reduced by one-half with respect to interest paid by corporations.

individuals suffer additional local taxes and surcharges, the effect being to increase the top rate of 20% to 31.23%.

Class C-1 covers only income from liberal professions. Again, the first \$387 (240,000 Lire) is exempt. Income in excess of that, up to \$1548 (960,000 Lire), suffers a 4% rate. The top federal marginal rate of 8% on the balance is further increased by additional local taxes and surcharges, rising to 13.95%.

Class C-2 covers income from employment in other than a liberal profession. While the exemption and basic rate structure applicable to the latter is carried over to this fourth class, additional local taxes and surcharges here increase the top 8% rate only to 9.15%. The employer is responsible to withhold this tax.

(e) *The complementary progressive tax on an individual's aggregate income.*—In computing an individual's aggregate income for the purpose of determining the complementary progressive tax, a general personal allowance of \$387 (240,000 Lire) is first deducted from gross income. Another deduction of \$81 (50,000 Lire) is allowed for each dependent. Life insurance premiums as well as the previously described separately scheduled taxes may also be deducted from gross income. In the end, the progressive complementary tax will not actually be charged unless the individual's aggregate income, *before* the foregoing allowances, exceeds \$1161 (720,000 Lire).

The progressive scale on the amount actually subject to tax begins with a basic rate of 2% (increased by surcharges, etc., to 2.24%) on taxable amounts up to \$387 (240,000 Lire), and extends upward to 50% (increased by surcharges, etc., to 54%) on taxable amounts in excess of \$806,452 (500 million Lire). Progression is not nearly as intense as in America for moderate incomes. For example, the marginal basic rate (before surcharges) for \$25,000 (15½ million Lire) is approximately 10%, and for \$50,000 (31 million Lire) it approximates 14%.

(f) *The complementary tax on corporate excess profits and capital.*—The corporate tax which complements the separately scheduled assessments is not a typical income tax nor are the rates progressive. It is more closely akin to a combined capital and excess profits tax. First, a rate of .75% is imposed on capital and reserves. Coupled with this is a 15% tax on those profits which exceed 6% of the capital and reserves. In computing these profits, the previously described separately scheduled assessment (R.M.) on business income is deductible.

In the case of foreign corporations, the capital levy only reaches investments in Italy.

(g) *Cumulative effect of taxes imposed on distributed business income of corporations.*—While income derived by a corporation from the conduct of business suffers a separately scheduled corporate assessment as well as the complementary tax imposed on corporate enterprises, dividends received by individual shareholders are not subject to another separately scheduled assessment. They are subject, however, to the complementary progressive tax imposed on individuals. The same immunity from a second separately scheduled assessment applies if the shareholder is a corporation; but the dividend will be included in the recipient corporation's profits for the purpose of computing its complementary excess profits tax, if any. American parent companies would not even pay this tax, however, with respect to dividends received from an Italian subsidiary.

If it be assumed that the distributing corporation's taxable profits equalled 10% of its capital and reserves, its tax load would be computed as in Table I L.

TABLE I L

Separately scheduled assessment	
—Effective rate under Category 3 (R.M.) ³⁵	31.23%
Capital tax	
—Effective rate on capital	.75%
—Ratio of capital to profits	10X
—Effective rate on taxable profits	7.5 %
Excess profits tax	
—15% of $\frac{1}{10}$ of profits; effective rate	6. %
Total effective corporate rate	<u>44.73%</u>

Since an individual does not suffer a separately scheduled tax on dividends, the tax impact on him, as distinguished from the corporation, depends on the moderately progressive rates of the complementary tax on his aggregate income. Subjection of dividends to but one tax in the hands of individuals has the net effect, if the corporate tax is ignored, of creating a substantial tax differential between dividend income and other forms of income. The differ-

³⁵ It will be recalled that this rate applies only to income in excess of \$6480; lower incomes are subject to a basic rate of 18%, increased by surcharges to 27.85%.

ence is particularly striking in the case of low and moderate incomes. The substantial character of the differential in these settings arises out of the fact that the effective rate of the additional separately scheduled assessments on other types of income, e.g., employment income, begins with a higher rate and rises more quickly than the progressive rates of the complementary tax on aggregate income. Illustratively, the cumulative effect of both taxes on employment income of \$2,640 (1½ million Lire) earned by a single taxpayer is 7.22% contrasted with an effective single tax rate of 2.89% for a like amount of dividend income. A married taxpayer with two children, on like amounts of income, would suffer a total effective rate of 6.80% on employment income and only 2.47% on dividend income.

(h) *Italian concept of gross income.*—The gross income concept is roughly similar to that in the United States with two prime exceptions. First, income from rural property is always based on an estimate as is other income in the absence of adequate records. Second, capital gains are not always included in the tax base. For example, an investment purchase of one house followed shortly thereafter by a sale will not lead to inclusion of any of the realized gain. But the converse will be true if the taxpayer regularly speculates, i.e., regularly buys and sells houses, securities, etc., and in such case the ordinary rates are applied. This speculative element is always implied in the case where an enterprise sells fixed business assets. With respect to those entities taxed on the basis of their balance sheets, capital gains may be taxed before they are realized, i.e., earlier—when and if entered in their accounting records.

(i) *Italian concept of "taxable" income.*—Permissible deductions from gross income in arriving at taxable income are similar to those in the United States. Special comment need be made only with reference to the deductions for taxes, interest, and depreciation, together with the treatment of inventory.

In computing taxable income for purposes of the corporate or individual complementary taxes, deduction may be taken for the separately scheduled assessments (including the R.M. tax) as well as indirect taxes incurred in the production of income.

Interest actually paid on loans associated with the production of income is quite generally deductible, even where paid to a parent company, provided the charge does not exceed a reasonable amount.

Depreciation is generally computed by the straight line method, suggested rates having been worked out by the Finance Department, in consultation with industry and commerce, for various types of items. Accelerated depreciation may also be used in connection with construction of new plants or modernization of old plants. Indeed, allowances in addition to normal depreciation may be taken in the first four years up to a total of 40% of cost, but not exceeding 15% in any one year.

Inventories are valued at cost or market, whichever is lower. Identification may be made according to LIFO as well as other methods.

(j) *Payment and the taxable year.*—While income is calculated on a yearly basis, Italy now allows operating losses to be carried forward, if need be, into the five succeeding years. Carry-backs are not permitted.

Income is generally reported according to the calendar year, though entities which report their income on the basis of balance sheets use their respective accounting years.

The tax is levied in two installments, a provisional levy designed to facilitate current reporting, and then a definitive levy. The provisional levy uses the past experience of the taxpayer as a yardstick. For example, in the case of individuals and partnerships, the provisional tax for 1961 is determined by reference to that income which was produced in 1959 and declared in March, 1960. The definitive tax is then assessed on the actual income of 1961, as declared in 1962. Corporations which are taxed on the basis of their balance sheets, according to their accounting year, use more recent past experience in computing the provisional tax. The provisional tax for 1961 is determined by reference to income produced in 1960 and declared in 1961. But again the definitive tax for 1961 will be that year's actual income, as declared in 1962.

(k) *The relevance of residency.*—The principle of territoriality governs the basic separately scheduled taxes (income from rural and urban property, from farming, and the R.M. tax). These reach only income derived from sources in Italy, the residence of the taxpayer being irrelevant. However, in the case of an Italian business enterprise, for the purposes of these basic taxes the entire income will be deemed to have its source in Italy, except to the extent it is earned by a foreign permanent establishment which has its own administration and accounting system. Income earned by

a permanent establishment located in Italy is deemed, of course, to have its source there.

A slightly different theory of jurisdiction governs the complementary progressive tax on individuals and the excess profits tax on corporations. Resident citizens of Italy are subject to the former tax with respect to their entire income, regardless of origin. Resident aliens, on the other hand, initially suffer this tax only with respect to income having its source in Italy, but income from foreign sources will be reached when remitted.

The excess profits tax on corporations, like the complementary progressive tax on individuals, reaches the entire income of Italian corporations without regard to the place of origin. On the other hand, foreign corporations and other entities with a permanent establishment in Italy are subject to this tax only with respect to their income from the establishment.

(1) *The cost of retaining versus the cost of distributing profits to an American enterprise.*—Because of the cumulative effect of two principles, Italian direct taxes will generally be the same whether an American enterprise conducts its affairs in Italy through a branch (permanent establishment) or through an Italian subsidiary. The first contributing principle is to the effect that the corporate tax in Italy is unaffected by the question of whether or not profits are distributed. The second involves the fact that, by treaty, American corporations are free from direct taxes with respect to any dividends received from an Italian subsidiary. Accordingly, with reference to *Italian* direct taxes, the form in which the American enterprise conducts its affairs in Italy, and the question of whether it plans to have the foreign facility retain or distribute profits, are not material considerations. Because of the neutral position reflected by the Italian tax system toward these matters, Italy does not need, nor does it have, a penalty tax on unreasonable accumulation of profits.

If the foreign facility is housed in a subsidiary corporation, its retained profits can be capitalized without direct tax costs through the issuance of stock dividends. Such shares would not be deemed income even under Italian national law. Nor would there be a direct tax on such shares at the point of disposition or liquidation, for Italy does not reach such capital gains.³⁶ However, capitaliza-

³⁶ This relates only to the shareholder. A corporation would be taxable according to the ordinary rates if it realized a capital gain in the course of winding up its affairs.

tion would lead to certain indirect tax costs in the forms of registration fees and stamp duties.

(m) *Disposition of an enterprise.*—Disposition and liquidation of a corporate enterprise can give rise to three different gains. Realized gain by the corporation, on the sale of fixed assets will normally be deemed taxable speculative gain. Any hidden reserves must also be restored to profit in computing the corporation's income. Finally, the shareholders, on relinquishing their shares, will be deemed to realize taxable income but only if the gain fits in the previously described speculative category, i.e., was enjoyed by a taxpayer who frequently buys and sells securities. Also only in this latter case would a merger result in any tax on shareholders.

Death of an individual who owns all or a part of an enterprise (proprietorship or partnership) does not serve to terminate the enterprise and will not be deemed a taxable disposition where the business is carried on by his surviving heirs or partner.

SUBSECTION 2. OTHER SIGNIFICANT TAXES

(a) *Taxes on capital and capital transfers.*—There are only two taxes in Italy which resemble a property tax, and these have a limited sweep. The most general of them relates to the complementary tax on corporations. It will be recalled that one of the factors associated with that tax involves a .75% flat rate tax on the corporation's capital and reserves.

The second and a more limited type of property tax involves a flat rate .05% annual levy on industrial bonds issued by Italian corporations.

While Italy does not have a general property tax, documents which must be registered, and these include those involving the transfer of property for money's worth, are subject to registration duties or fees. The general rate is 4%.

Italy also employs a gift tax, using rates identical to those associated with succession duties which are applicable to inheritances. Testamentary transfers are also subject, however, to an estate tax. In terms of jurisdiction, the gift tax is imposed on all gifts made within Italy, and this includes all of those which are registered in that country. Succession duties and the estate tax, on the other hand, are imposed only on property situated within Italy at the time of the decedent's death, his domicile, residence, and nationality being irrelevant.

(b) *Turnover taxes and excise duties.*—Italy relies upon indirect taxes to a much greater degree than most western countries. And the Imposta Generale Sull'entrata (gross receipts tax) is the most important of its indirect taxes. The normal rate is 3.3% though retail sales are fully exempt. Since some tax is imposed on each transfer of goods (except at retail) and rendition of services for money's worth, the effect is to increase the total tax load by reference to the number of enterprises through which goods pass in the course of developing and disposing of a finished product. In many of the cases where this cumulative principle would provide integrated companies with a substantial competitive advantage, Italy, like Belgium, has selected one common type transfer as the point of impact for a single turnover tax.

To whittle down at least some of the tax advantage which imports might otherwise enjoy (laying aside the matter of tariffs), the turnover tax is first imposed at the point of importation.³⁷ On the other hand, to neutralize the effect of the tax on export trade, exports are freed from the tax. In fact, turnover taxes previously charged in connection with the development of the exported item are refunded.

In addition to the foregoing general turnover tax, special excise duties have been placed on certain consumers' goods, such as liquor, sugar, tobacco, and mineral oils. Moreover, the state has monopolized the tobacco and salt industries.

(c) *Other miscellaneous taxes.*—Miscellaneous revenue measures include fees for the registration of all types of legal documents and stamp duties on the instruments themselves. There is also a motor vehicle tax, imposed on the basis of horsepower or deadweight.

Most important to local units is the Imposta di Famiglia. This tax is levied on the total income of a family, the progressive rates ranging from 2 to 12% (16% with surcharges).

SECTION E. LUXEMBOURG

SUBSECTION I. INCOME, NET WEALTH, AND ENTERPRISE TAXES

(a) *In general.*—During World War II, Germany converted Luxembourg into a province, and the latter's tax system

³⁷ This matter, insofar as it relates to exports from the United States to Italy, is covered more fully in PART II, *infra*.

was redesigned so as to conform closely to that prevailing in Germany. While Luxembourg made some post-war changes, the two systems are still quite similar today, the most striking difference being that Luxembourg does not discriminate between distributed and undistributed profits in determining a corporation's income tax.

Generally speaking, individuals are only subject to one national income tax, the progressive rates of which are applied to aggregate income and, in the case of single persons, reach a maximum effective rate of 54%. The remuneration of a corporate director (member of board in control) is also subject, however, to a second special tax. In addition, individuals pay a general property tax, the rate being .5% of net wealth. Finally, businessmen suffer a three-factor municipal enterprise tax, geared to profits, net wealth, and payroll.³⁸ This assessment is deductible in computing taxable income for federal purposes as well as in computing the profit factor associated with this same tax.

Corporations are also subject to a national income tax. With the exception of small enterprises, however, a flat rate is used. This is complemented also by a flat rate tax on net wealth and by the deductible three-factor³⁹ municipal enterprise tax.

While corporate dividends are also generally subject to the national income tax, an effort has been made to reduce the degree of multiple taxation of corporate earnings by freeing inter-corporate dividends from tax in those instances where the receiving corporation holds a substantial interest in the distributing company.

(b) Income, enterprise, and net wealth taxes on individuals.

—The general progressive income tax on individuals (*Impôt sur le Revenu des Personnes Physiques*) reaches all types of ordinary income except for a limited exclusion in cases where a total of \$60 (L. Fr. 3,000) or less is derived from incidental services. While remuneration received for performing the role of corporate director is subject to a *separate* flat rate 20% withholding tax, in effect, the net amount of remuneration received—i.e., the remuneration less the withheld 20% tax—is also separately subject to the progressive rates of the general income tax or, in the case of a nonresident director, to a flat 8% general income tax, provided the remuneration does not exceed \$1,060 (L. Fr. 53,000). In effect, while a

³⁸ Not all municipalities use the third factor, payroll, though a number of the important ones do. The basic rate is .2% and surcharges increase this to an average total of 1.2%.

³⁹ *Ibid.*

director's remuneration is subject to both taxes, the special flat 20% tax itself is deductible from gross income in computing the taxable base of the general income tax. If all of a resident director's gross remuneration would fit, say, into the 40% bracket of the general progressive tax, the privilege of treating the additional flat 20% as a deduction from gross income has the effect of reducing the added impact of the *special* tax to 12%. This effect is to be contrasted with that which stems from other withholding taxes which are integral parts of, and serve as *credits* against, the general income tax itself.

Built into the tables reflecting progression in the rate structure are allowances for married men and additional amounts for those with children. The table of effective rates, appearing in Table I M, indicates the significance of those allowances and the degree of progression.

TABLE I M

<i>Income</i>	<i>Single Taxpayer</i>	<i>Married Taxpayer</i>	<i>Married and 1 Child</i>	<i>Married and 2 Children</i>	<i>Married and 4 Children</i>	<i>Married and 5 Children</i>
\$ 720						
Fr. 36,000	.56%	—	—	—	—	—
\$ 1,000						
Fr. 50,000	6.00%	2.00%	—	—	—	—
\$ 2,000						
Fr. 100,000	14.73%	8.76%	6.57%	4.33%	—	—
\$ 4,000						
Fr. 200,000	24.08%	15.32%	12.60%	10.12%	5.96%	4.10%
\$ 6,000						
Fr. 300,000	30.01%	19.81%	17.36%	14.88%	10.74%	8.81%
\$ 8,000						
Fr. 400,000	34.33%	24.45%	22.22%	19.95%	16.03%	14.21%
\$ 10,000						
Fr. 500,000	37.71%	28.43%	26.45%	24.44%	20.89%	19.24%
\$ 15,000						
Fr. 750,000	43.94%	36.05%	34.53%	32.99%	30.24%	28.92%
\$ 20,000						
Fr. 1,000,000	47.71%	40.82%	39.68%	38.52%	36.45%	35.47%
\$ 25,000						
Fr. 1,250,000	49.51%	44.06%	43.23%	42.22%	40.56%	39.79%
\$ 30,000						
Fr. 1,500,000	50.42%	46.48%	45.72%	44.95%	43.57%	42.92%
\$ 35,000						
Fr. 1,750,000	50.94%	48.27%	47.62%	46.96%	45.77%	45.22%

Individuals also pay a flat .5% tax on net wealth (*Impôt sur la Fortune*). The consequent extent to which the national direct tax load on income from capital exceeds that on earned income

(e.g., from employment) can be illustrated by a case where a taxpayer derives his entire income from capital which yields 10% on its market value. In this circumstance, absent other considerations, the .5% tax on net wealth would be equivalent to an additional 5% tax on the income therefrom.

In addition to the two foregoing taxes, those engaged in the conduct of a business are also subject to a three-factor municipal enterprise tax (*Gewerbesteuer*).⁴⁰ Basic rates of 4% on profits in excess of \$4,000 (L. Fr. 200,000) for individual proprietors, and in excess of \$1,600 (L. Fr. 80,000) for companies, have been surcharged in varying amounts, increasing the municipal tax on profits to between 5.5% and 8.4% and the tax on net wealth to between .28% and .42%. However, the ultimate impact of this tax is reduced by the fact that it is deductible in computing the base of the national income tax and may also be a debt in determining one's net wealth.

(c) *Income, net wealth, and enterprise taxes on corporations.*—All juridical entities (e.g., *société anonyme* and the *société à responsabilité limitée*) are subject to a national income tax (*Impôt sur le Revenu des Collectivités*) on aggregate income, the normal rate being 40%. Progressive rates are applied, however, to enterprises with small incomes. Because the applicable rate in the progressive schedule is applied to the small company's *entire* income, not just to that portion falling within a given bracket, it was necessary to add a marginal relief schedule in order to even out rate changes. The basic progressive rates, and the marginal relief provisions, follow.

<i>Corporation's Total Profit</i>	<i>Basic Rate Applied To Total Profit</i>	<i>Marginal Relief: Tax Shall Not Exceed</i>
1. \$8,000 (Fr. 400,000)	20%	
2. In excess of \$8,000 (Fr. 400,000) but under \$20,000 (Fr. 1,000,000)	30%	\$1,600 (Fr. 80,000) plus 50% of profit over \$8,000 (Fr. 400,000)
3. Over \$20,000 (Fr. 1,000,000)	40%	\$6,000 (Fr. 300,000) plus 72% of profit over \$20,000 (Fr. 1,000,000)

The basic rates of the three-factor ⁴¹ municipal enterprise tax (4% on profits and .2% on net wealth) and the varying surcharges

⁴⁰ *Ibid.*

⁴¹ *Ibid.*

are the same for corporations as individuals. Since corporations, like individuals, may deduct this tax in computing the general income tax base, the prime difference between the two relates to the fact that only individuals enjoy an exemption for the first \$10,000 (L. Fr. 500,000) in computing the net wealth factor.

Also in the case of corporations and private companies (*société à responsabilité limitée*), for purposes of the net wealth tax, minimum property holdings are assumed, the respective assumed amounts being \$10,000 (L. Fr. 500,000) and \$4,000 (L. Fr. 200,000).

(d) *Combined impact of corporate and individual direct taxes.*—As noted earlier in the setting of Germany, certain variables affect the degree to which corporate earnings will be absorbed by direct taxes on corporations and their stockholders. The progressive character of the income tax's rate structure, as applied to individuals (and small corporations), is one such variable. Differences in the amount of surcharges added by various municipalities to the basic rates of the municipal enterprise tax is another. Further variables, associated with net wealth taxes on corporations and individuals, include the relationships of corporate net wealth to corporate earnings and of stock values to dividends. These will vary from industry to industry and among corporations within an industry.

The cumulative effect of direct taxes on distributed corporate earnings can be measured, however, and compared to the tax load on an individual's earned income, by making certain assumptions. Those indulged in here are similar to those made in discussing the tax loads of other countries and include an individual with modest income (\$2,380 or L. Fr. 119,000), municipal enterprise tax rates of .4% on net wealth and 8% on profits, and a corporation which earns 10% on its net wealth while its stock yields 4% on its market value.

Under the foregoing circumstances, the corporation would have to earn approximately \$4,925 (L. Fr. 246,203) in order to pay a dividend of \$2,380 (L. Fr. 119,000), the effective total rate of the three taxes (income, net wealth, and enterprise) on its earnings being 51.67%.

An unmarried individual whose entire income was derived from a dividend of \$2,380 (L. Fr. 119,000) on stock worth \$59,500 (L. Fr. 2,975,000) would pay a property tax of \$287.50 (L. Fr. 14,375), an amount equal to 12% of his dividend, and an income tax

of \$379.10 (L. Fr. 18,955),⁴² this being 15.9% of his dividend. But when his personal tax load is treated as a percentage of the original corporate earnings, rather than a percentage of his dividend, the following cumulative effect emerges.

Total corporate direct taxes	\$2,545.	(Fr. 127,203)	
Individual direct taxes			
Property tax	288.	(Fr. 14,375)	
Income tax	379.	(Fr. 18,955)	
	<u>\$3,212.</u>	<u>(Fr. 160,533)</u>	
Total direct tax load	\$3,212.	(Fr. 160,533)	= 65.2%
Original corporate earnings	\$4,925	(Fr. 246,203)	

The cumulative effect of direct taxes on this type of capital may be compared with an individual who earns \$2,380 (L. Fr. 119,000) from employment. His total tax of \$345 (L. Fr. 17,237)⁴³ would be only 14% of his income.

(e) *The Luxembourg concept of gross income.*—In practice, gross income, as such, is not actually computed. The aggregate income against which the rates are applied actually consists of the net incomes from each of the various sources.

In the case of individuals, exclusion of capital gains is much more significant than the one other common tax free benefit, specifically, an amount not in excess of \$60 (L. Fr. 3,000) derived from incidental services. The immunity accorded capital gains, such as those derived from the sale of stock or a home, is lost, however, if the transaction is deemed speculative in character. And that characterization is applied, except for certain exceptions relating to shares in Luxembourg corporations and indebtedness running against residents, whenever movables are held less than 1 year or, in the case of immovables, less than 2 years. Also included in the taxable category are profits derived from the sale of assets used in the taxpayer's business, such as office equipment. In fact, even the conversion of a proprietorship into a limited liability company is deemed a taxable event except where the realized gain is less than \$2,000 (L. Fr. 100,000). Finally, as is true in Germany and the Netherlands, gains derived by an investor from the sale of domestic

⁴² The standard deduction for personal expenses (\$80) was taken into account.

⁴³ The standard deductions for personal expenses and business costs were taken into account, being, respectively, \$80 and \$120.

or foreign corporate stock will be taxed if the individual holds a "considerable interest" in the corporation. Such an interest will be deemed to exist if the taxpayer or certain related parties owned more than 25% of the nominal paid-in capital either at the moment of sale or at any point during the preceding 5 years. But even in such cases, small profits are ignored; the gain will not be taxed if not more than 1% of the corporation's capital stock is sold and the amount of the resulting gain falls below a certain figure. Even where capital gains are taxed, in the case of individuals, a special rate is applied, ranging from 12% to 27%. Normally a rate equal to one-half of that applied to the taxpayer's ordinary income will be used.

There are two significant instances where corporations depart from the profit concept applicable to individual businessmen. First, corporations reflect all of their capital gains just as they reflect income from regular business activity. Second, the so-called *Schachtelprivileg* permits dividends received by a corporation to be excluded if the recipient holds at least 25% of the stock in a domestic distributing corporation.

The profit concept utilized by the various municipal enterprise taxes is quite similar to that associated with the national income tax. The prime differences, in the case of the enterprise tax, relate (1) to the non-deductibility of interest on long-term indebtedness and of salaries paid to corporate managers who have substantial stock interests (25% or more), and (2) to the permitted exclusion of income from foreign permanent establishments.

(f) *The Luxembourg concept of "taxable" income.*—In computing the income tax base, individuals are allowed to deduct certain personal expenses, such as interest. Also up to a certain amount, individuals may deduct premiums paid on life, health, and certain other types of insurance. Finally, deduction is allowed for certain extraordinary personal expenses (illness, death, etc.) in excess of a minimum amount which depends upon the taxpayer's income and family status. Instead of itemizing the personal expenses, the taxpayer may elect to take a standard deduction of \$80 (L. Fr. 4,000) plus the allowance for extraordinary charges. Also in lieu of itemizing business expenses, wage and salary earners may take a second standard deduction of \$120 (L. Fr. 6,000).

Deductible business expenses are very similar to those in the United States, and include wages, salaries, rent, interest—including

reasonable amounts paid to a parent company or other shareholder, excise duties, enterprise taxes, and depreciation.

Prime differences between the two systems in the business expense area relate to the non-deductibility under Luxembourg law of director's fees and property taxes (on net wealth) and to certain differences in the treatment of depreciation and inventories.

While depreciation is usually computed by the straight line method, in some cases the declining balance method is permitted.

As previously noted, upon the sale of business assets, the difference between book value and the selling price is generally taxed. To compensate for earlier inflation, however, it has been necessary to adjust the basis by reference to a system of coefficients. Table I N sets forth the table of coefficients which apply both to historic cost and to its adjustment for depreciation previously taken.

TABLE I N

<i>Accounting year closed in</i>	<i>Coefficients</i>	<i>Accounting year closed in</i>	<i>Coefficients</i>
1918 or previous years	26.57	1937	3.86
1919	12.09	1938	3.75
1920	6.47	1939	3.77
1921	6.63	1940	3.46
1922	7.11	1941-1944	2.23
1923	6.01	1945	1.78
1924	5.35	1946	1.42
1925	5.11	1947	1.36
1926	4.31	1948	1.28
1927	3.42	1949	1.21
1928	3.28	1950	1.17
1929	3.05	1951	1.08
1930	3.—	1952	1.06
1931	3.35	1953	1.06
1932	3.86	1954	1.05
1933	3.87	1955	1.05
1934	4.02	1956	1.05
1935	4.10	1957 and succeeding years	1.00
1936	4.08		

Apart from regular depreciation, a special additional allowance was authorized for investments in new plant and equipment during

the years 1959 and 1960. A total additional allowance equal to 20% of cost, up to a maximum deduction of \$100,000 (L. Fr. 5,000,000), could be spread over a minimum 4-year period.

While inventories must generally be reflected on the basis of historic cost, the listed selling price of an entire stock may be used if it is lower than cost. Generally, too, goods on hand will be identified by reference to FIFO, though LIFO is an available alternative.

(g) *Payment and the taxable year.*—While income must generally be determined by reference to the calendar year and the accrual method, businesses may select a fiscal year coinciding with their accounting year. Provision has also been made for a two-year carry-forward, but no carry-back, in the case of operating losses.

Two devices are used to keep payments on a current basis. A system of quarterly provisional payments, which serve as credits against the later definitive assessment, is complemented by provisional withholdings in the case of certain types of income. Tax is usually withheld on interest at the rate of 5%, on dividends (Impôt sur les Revenus des Capitaux) at the rate of 15%, and on wages (Impôt sur les Salaires) according to a progressive table which takes account of personal allowances and the two standard deductions (\$80 or L. Fr. 4,000 for personal expenses and \$120 or L. Fr. 6,000 for business expenses). The regular withheld wage tax is treated as a final levy only where the taxpayer has but one source of employment or pension income which does not exceed \$2,800 (L. Fr. 140,000) and then only if his income from other sources does not exceed \$100 (L. Fr. 5,000).

(h) *The relevance of residency.*—Residents of Luxembourg, corporate or individual—and in the latter case without regard to nationality, are liable for income tax on income from without as well as that from within the country. The only unilateral provision dealing with double taxation involves allowance of the foreign tax as a deduction in computing the income tax base. Peculiar to the Luxembourg system is the notion that certain persons will be treated as residents for tax purposes though they do not live within the country. This category includes owners, managers, and deputy managers of corporations resident in Luxembourg. It also includes any director who is also actively associated with a management function.

Nonresidents are only taxable on that income which is deemed to have its source in Luxembourg. This includes income derived

from domestic agricultural enterprises, from non-agricultural permanent establishments or through a representative, from renting domestic property, from the independent exercise of a profession or other employment within Luxembourg, and income derived from movable capital, such as shares and debentures of Luxembourg corporations and indebtedness against other residents—including also profit from the sale of shares where (a) the vendor owned a “considerable interest” in the corporation or (b) the profit fits into the so-called speculative category. The nonresident is also reached with reference to any income mentioned in § 22 of the Income Tax Act insofar as tax is withheld at the source or where speculative gain is derived from the sale of land.

Subject to the foregoing jurisdictional differences, those principles which determine a resident's income also apply to nonresidents. Illustrative are the previously mentioned special rules relating to capital gains. Nonresidents who are other than wage earners are subject, however, to a minimum income tax of 12%. This is also the percentage withheld on royalties. Nonresident directors' fees are subject to the special 20% director's tax as well as the regular income tax. Accordingly, to the withheld 20% special tax, Luxembourg has added an additional 8%, the total amount withheld being 28%.

With reference to the net wealth tax, nonresidents pay only on that property situated in Luxembourg, such as immovables or assets associated with a permanent establishment located there.

(i) *The comparative costs of retaining and distributing profits.*—In contrast to the situation in Germany, a corporation's own taxes will be the same whether it retains its profits for expansion or distributes them to stockholders. Luxembourg does not even have a penalty tax, like that in the United States, relating to unreasonable accumulation of profits. Since that part of the profits which are distributed will normally be taxed to the stockholders, it is less expensive to expand out of profits than to have those shareholders contribute additional capital from dividends which they have received. For example, where a parent company in the United States holds the shares, the subsidiary's use of its own profits for expansion will serve to avoid the 15% withholding tax (*Impôt sur les Revenus des Capitaux*) imposed by Luxembourg on dividends distributed to an American parent company. Where the subsidiary's profits are ploughed back in this fashion, the total tax load imposed

by Luxembourg will equal that which would be imposed had the expanding facility been operated as a branch of the American corporation. The Luxembourg tax load will be different, however, at that point when profits are no longer needed for expansion and are to be extracted by the parent. Profits of the branch will be taxed only once, in the year earned. A subsidiary will have suffered a like tax, and, in addition, dividends distributed to the parent will suffer a second tax, 15% of the dividend being withheld. This disadvantage of the subsidiary arrangement can be partially offset if the parent company's original capital contribution consisted, in part, of loans. The subsidiary could deduct the annual interest payments in computing its income tax base, but not its municipal enterprise tax base. A branch, of course, could not enjoy such a deduction under either tax.

(j) *Disposal of an enterprise.*—Disposition by a corporation of its assets is a taxable event, the difference between its adjusted basis and the amount realized being includible in gross income. Upon liquidation of the corporation and distribution of the proceeds, any gain enjoyed by a shareholder, measured by the difference between the adjusted basis of his shares and the amount realized, will be taxable if he has a "considerable interest" (25% or more) in the corporation or, in the case of residents, if his gain fits into the so-called speculative category. Corporate shareholders must also include such gains in their income.

Normally, a merger is also deemed a taxable event, the amount realized by the corporations again being the difference between the adjusted bases and fair market value of their assets. But under certain conditions, if it can be guaranteed that this differential will suffer a tax later on, the gain realized at the point of amalgamation will not be recognized for tax purposes.

SUBSECTION 2. OTHER LUXEMBOURG TAXES

(a) *Turnover taxes and excise duties.*—The general turnover tax is a multiple stage arrangement in the sense that it is applied to each transfer of goods which may take place in the course of developing a finished product. To reduce the impact on middlemen, i.e., on entrepreneurs who deliver merchandise to another entrepreneur without changing its basic nature, the normal rate of 2% is reduced to .5%. Retail sales to consumers, however, bear the regular rate. Indeed, big retail stores which enjoy a 75% retail

turnover pay $2\frac{1}{2}\%$, provided their previous year's turnover reached \$800,000.

The turnover tax applies pretty much across the board. Services bear the same rate as goods. But certain goods, e.g., a common necessity like bread, are taxed at a reduced rate of 1%. While transfers of luxuries normally suffer only the regular 2% rate, separate excise duties are imposed on certain products such as beer, tobacco, etc.

Tax equality between domestic and foreign products is achieved in some degree by imposing the regular rate on imports at the point of importation.⁴⁴ To make domestic products more competitive on the world market, export transactions themselves are free of the tax. But no attempt is generally made to refund turnover taxes previously paid in connection with earlier stages of production or distribution. Metallic products, such as wagons and machinery, are exceptions; a refund of .5% is allowed.

(b) *Registration and stamp duties.*—A number of transactions are subject to a registration duty (*Droit d'Enregistrement*).⁴⁵ These include the issuance of corporate bonds, shares, and the sale or donation of real estate. While a flat 6% is applied to sales of real estate, donations suffer a progressive duty, running from 1.5% to 12%.

Companies also pay an annual tax on their share capital and indebtedness (*Droit d'Abonnement*). A number of documents also suffer special stamp duties.

(c) *Miscellaneous taxes.*—Three of the most important miscellaneous taxes involve levies on motor vehicles, measured by weight or horsepower, succession duties, and a communal land tax.

The death duty (*Droit de Succession*) is imposed upon the heirs of a person deceased in Luxembourg, and is measured by the net value received. Progressive rates, dependent upon the relationship between the parties and the amount acquired, run from 0 to 15%. Where the decedent is a nonresident, a different tax (*Droit de Mutation par Décès*) with about the same rate schedule is imposed; it reaches the gross value of his real estate in Luxembourg.

The communal land tax (*Impôt Foncier*) is measured by the

⁴⁴ This matter, insofar as it relates to exports from the United States to Luxembourg, is more fully considered in PART II, *infra*.

⁴⁵ Registration duties and the like are more fully considered in Section G, PART III, *infra*, in connection with the consideration of Luxembourg as the site for a holding company.

value of real estate, and carries basic rates which vary from .5% to 1%. Local surcharges on this rate also vary.

SECTION F. NETHERLANDS

SUBSECTION I. INCOME AND NET WEALTH TAXES

(a) *In general*.—Contrary to the case in Belgium and France, individuals in the Netherlands are generally subject to but one income tax, the progressive rates of which are applied to aggregate income and reach a maximum effective rate of approximately 70% for single persons. Only the remuneration received by a member of a corporate board of directors is subject to a special income tax, and it is in addition to the regular tax. Except in the case of this tax, amounts which are withheld in connection with the system of current payment are generally integrated with the regular income tax, serving as credits.

Because earned income was not given preferential treatment in the income tax legislation itself, the Netherlands have for years imposed a separate flat rate property tax. It differs from that traditionally used by local units in the United States in that the base consists only of net wealth, rather than the gross value of items in which the taxpayer has an equity.

Corporations are subject to what is generally a flat rate income tax, though slightly more modest rates are applied in the case of those with little income. While dividends are also generally taxable in full, extreme multiple taxation is avoided by immunizing one type of inter-corporate dividend, specifically one received by a corporation which has substantial interest in the distributing company.

(b) *Income and net wealth taxes on individuals*.—The general progressive income tax on individuals (Inkomstenbelasting) reaches all types of ordinary income. While any remuneration of a corporate director ⁴⁶ is also subject to an additional flat 30% withheld tax on amounts in excess of \$263 (Fl. 1,000) plus another 20% on amounts in excess of \$1,315 (Fl. 5,000), only the net, after that special tax has been withheld, is actually included in the general income tax base. This reduces, of course, the actual degree to which the special director's tax is an additional burden. For example, if the *gross* remuneration would have otherwise fitted into

⁴⁶ The word "director" (commissaris) is used here to refer to any member of the board in control (commissarissenbelasting), not to the single so-called managing director (directeur).

the 40% bracket of the general income tax, allowance of what is tantamount to a deduction for the special director's tax is equal to a reduction of the latter's 30% rate to 18%.

Personal allowances for married persons and those with dependent children are built into the general progressive rate schedules which, in the case of single persons, reach a maximum effective rate of 70.5% on that part of one's taxable income in excess of approximately \$20,000 (Fl. 76,000). Table I O provides some idea of the impact of the tax and the degree of progression.

TABLE I O

Total Income		Approximate Effective Rate on Total Income					
<i>Dollars</i>	<i>Fl.</i>	<i>I</i> <i>Single</i>	<i>II</i> <i>Married</i>	<i>III/1</i> <i>M + 1</i>	<i>III/2</i> <i>M + 2</i>	<i>III/4</i> <i>M + 4</i>	<i>III/6</i> <i>M + 6</i>
\$ 394	fl. 1,500	1.5 %	0	0	0	0	0
526	2,000	4.5 %	0	0	0	0	0
656	2,500	6.0 %	2.9%	0	0	0	0
789	3,000	8.8 %	4.7%	2.06%	0	0	0
1,578	6,000	16.3 %	11.0%	8.7 %	6.5%	2.7 %	0
2,367	9,000	21.1 %	14.9%	12.8 %	10.8%	7.1 %	3.75%
3,156	12,000	25.1 %	18.4%	16.5 %	14.6%	11.0 %	7.65%
3,949	15,000	28.7 %	21.8%	20.1 %	18.2%	14.75%	11.4 %
5,260	20,000	33.7 %	26.9%	25.2 %	23.4%	20.3 %	17.25%
6,575	25,000	38.2 %	31.2%	29.9 %	28.4%	25.7 %	22.9 %
7,898	30,000	47.8 %	34.8%	33.5 %	32.3%	29.8 %	27.5 %
10,520	40,000	46.9 %	40.0%	39.0 %	38.1%	36.0 %	34.1 %
13,150	50,000	50.7 %	43.9%	43.1 %	42.2%	40.5 %	38.8 %
19,725	75,000	56.7 %	50.6%	50.0 %	49.4%	48.2 %	47.0 %
26,300	100,000	60.04%	54.9%	54.4 %	53.9%	53.0 %	52.0 %

While a separate net wealth tax has usually been imposed at a normal rate of .5%, this has been temporarily increased to .6% for 1959 and 1960. Exemptions serve to immunize the following amounts:

—Single taxpayer	\$5,921	(Fl. 22,500)
—Married taxpayers	7,895	(Fl. 30,000)
—Additional amount for each depen- dent child	1,974	(Fl. 7,500)

Laying aside the matter of exemptions for the moment, if it be assumed that the taxpayer's capital yields only 4% on its market value, the .6% tax on net wealth would be equivalent to 15% of net income. And this entire amount constitutes an additional burden, for in contrast to certain other Common Market countries, the net wealth tax is not deductible in determining the regular income tax

base. There is then a significant difference between the tax loads borne by earned and unearned income in the Netherlands.

(c) *Income tax on juridical entities.*—The corporate income tax (Vennootschapsbelasting) is also applied to aggregate income, the usual rate being 47%. A lower rate is applied only where the total income is less than \$13,150 (Fl. 50,000) in which case the first \$10,510 (Fl. 40,000) is taxed at 44% with the remaining \$2,640 (Fl. 10,000), if any, being taxed at 59%.

While dividends are generally includable in gross income, an exception is made in that case where inter-corporate dividends are received by a corporation which owns at least 25% of the distributing company's shares. This immunity is extended even to dividends received from foreign corporations (in contrast to the practice in Germany and Luxembourg), provided the distributing foreign corporation was itself subject to a foreign income tax. An investment company (holder of a so-called investment fund) is entitled to this privilege even though it holds less than a 25% interest, provided the company meets certain conditions. The Minister of Finance is authorized to grant the same privilege to other corporations which have small holdings, and usually does if the distributing corporation is engaged in a line of business related to that of the corporate stockholder and the particular stockholder-corporate relationship is deemed to be in the public interest.

(d) *Combined impact of corporate and individual direct taxes.*—While certain variables affect the degree to which corporate earnings will be absorbed by direct taxes on corporations and their stockholders, the number of such variables is not as great in the Netherlands as in certain other countries. This is due to the fact that a multiple-factor separate enterprise tax does not exist in the Netherlands nor is its net wealth tax applicable to corporations. Consequently, variables in the ratio of corporate assets to corporate earnings are not material. The prime variables involve a stockholder's particular income tax bracket and—in taking account of the personal net wealth tax—the changing ratios between the market value of his stock and its yield, as well as the relative significance of the exemptions to his total portfolio.

In order to neutralize these variables, Table I P assumes that the stockholder's shares yield 4% on market value and that his entire income is derived from these shares. Column 7 reflects the combined impact of corporate and personal taxes, and may be com-

pared with column 8 which reflects the percentage which would be absorbed by direct taxes if income equal to that earned by the corporation had been earned by a single individual through employment.

TABLE I P

<i>Company's Net Income</i>	<i>Corpo- ration In- come Tax</i>	<i>Dividend</i>	<i>Per- sonal In- come Tax</i>	<i>Property Tax</i>	<i>Total Tax</i>	<i>Total Tax %</i>	<i>Total Tax % if Col. 1 Were Em- ployment Income</i>
<i>1</i>	<i>2</i>	<i>3</i>	<i>4</i>	<i>5</i>	<i>6</i>	<i>7</i>	<i>8</i>
\$ 1,000	\$ 470	\$ 530	\$ 19	44	533	53.30%	9.82%
2,000	940	1,060	110	123	1,173	58.65%	16.91%
10,000	4,700	5,300	1,726	759	7,185	71.85%	45.16%
20,000	9,400	10,600	4,900	1,554	15,854	79.27%	56.42%
50,000	23,500	26,500	15,822	3,939	43,261	86.52%	66.09%
100,000	47,000	53,000	34,521	7,914	89,435	89.44%	67.66%
1,000,000	470,000	530,000	370,806	79,464	920,270	92.03%	70.22%

(In the above example deductions for old age premium have been taken into account.
\$1. = fl. 3.8)

(e) *The Netherlands concept of gross income.*—In practice, gross income, as such, is not determined. The tax base is calculated by aggregating the net incomes from each of the various sources, and from this amount certain allowable personal expenses and losses are deductible.

The previously described immunity for certain inter-corporate dividends constitutes the most significant exclusion for corporations. The latter do not enjoy, on the other hand, the most fundamental exclusion allowed individuals, that relating to capital gains. Even the gain technically realized by a corporation on shifting the assets of a branch into a newly created subsidiary is normally taxed. In contrast, the immunity extended to individuals embraces even speculative capital gains, though gains of two other types are includable.

First, it was easy to jump from the notion, that all profits made by a business—including, e.g., even interest and dividends—ought to be included, to the conclusion that profits from the sale of fixed business assets were also includable. By statute, however, gain realized on the sale of immovables belonging to an agricultural enterprise are not taxed provided such sales do not constitute a part of the enterprise's regular business activity.

The second major type of taxable capital gain is intimately related to the first. It involves gain derived from the sale of corporate shares by an individual investor who owns a considerable interest

in the corporation, domestic or foreign. Sale of shares in that circumstance has a practical resemblance in some degree to sale of business assets. Accordingly, the profit is taxable if at the moment of the sale or during the preceding five years the stockholder or related parties owned more than 25% of the nominal paid in capital. Such profit is not aggregated, however, with his other income; nor are the regular progressive rates applied. Instead, a separate tax is imposed, with rates ranging from 20% to 40%, depending upon the size of the taxpayer's other income.

(f) *The Netherlands concept of "taxable" income.*—Business expenses incurred by individuals serve as deductions in arriving at the tax base. Itemization of these may be avoided by wage and salary earners (including also those in the so-called liberal professions) through election to take a flat standard business deduction of \$26 (Fl. 100). If it can be demonstrated that the actual expenses did at least exceed that amount, the standard jumps to 5% of taxable income but in any case not in excess of \$158 (Fl. 600). Business deductions by wage or salary earners in excess of that amount are dependent upon itemization. In any event, certain personal expenses may also be deducted, including life annuity premiums to a maximum amount of \$947 (Fl. 3,600), charitable contributions the maximum deduction for which depends upon the size of the individual's income, and finally so-called extraordinary charges (illness, death, etc.) in excess of a minimum amount. As previously noted, additional personal allowances peculiar to married persons and those with dependent children are reflected in the rate tables, an extract from which appears in sub-topic (b), *supra*.

Business deductions enjoyed by individuals or corporations engaged in the active conduct of an enterprise are quite similar to those in the United States, and include wages, salaries, rent, interest—including reasonable amounts paid to a parent company or other shareholders, losses, charitable contributions up to a certain percentage of income, turnover taxes, and excise duties, but not income or property taxes. Particularly favorable arrangements for depreciation and the treatment of inventory deserve added comment.

Basic depreciation allowances are determined on the basis of historic cost, and, peculiar to the Netherlands, the first period may begin with execution of a purchase contract. Taxpayers are given considerable leeway in fixing the rate of depreciation, pro-

vided a consistent and sound policy is followed. Frequently the matter is handled through agreement with the tax inspector. Both fixed and variable rates, geared either to original cost or the adjusted basis (cost less depreciation previously taken), and dependent, for example, upon intensity of use, have been authorized.

Provision has also been made for accelerated depreciation and a special investment allowance. Originally, accelerated depreciation took the form of an initial deduction of $\frac{1}{3}$ rd of the cost price in the year an item was ordered or bought. However, the Minister of Finance has regularly used a complementary power to require that this initial allowance be spread over a longer period. In most cases he presently requires a four-year spread, not more than $\frac{1}{12}$ th of the cost price being deductible in the first year. Accelerated depreciation in the case of buildings is restricted to 6% a year, and may not be applied at all to office furniture or passenger cars.

A so-called investment allowance is quite distinct from the accelerated depreciation provision. The latter, but *not* the former, serves to reduce the book value of an asset. This incentive allowance, serving in effect to exempt rather than postpone the tax on income, was intended to promote industrial activity and incidentally compensate for some decline in the purchasing power of money. In this latter connection, the Netherlands does not utilize the system of coefficients used elsewhere.

The constantly changing provisions regarding the investment allowance now authorize a deduction, spread over two years, of 10% of historic cost.

As in the case of basic depreciation, taxpayers have considerable leeway in their treatment of inventories provided the method chosen is consistently followed and sound in terms of business practice. Valuation may be at cost, market, or at cost or market, whichever is lower. LIFO or the base stock method may be used as well as FIFO.

(g) *Payment and the taxable year.*—A system of current payment is accomplished through withholding taxes and provisional payments. The withholding tax on dividends (*Dividendbelasting*) is at the rate of 15%; withholding on wages (*Loonbelasting*) is geared to progressive tables which take account of deductible social security contributions. These two withholding taxes, like provisional payments and in contrast to the withheld tax on corporate directors' remuneration, generally serve as credits against the later definitive income tax assessment. The withholding tax on wages is itself the

final levy, however, where income from employment (including pensions) does not exceed \$1,815 (Fl. 6,900) ⁴⁷ and income from other sources is not in excess of \$53 (Fl. 200).

While the calendar year normally serves as the taxable year, businesses may elect a fiscal year corresponding to their regular accounting year. The provisions regarding net losses are also quite favorable. Generally they may be carried back one year and carried forward 6 years, if need be. Moreover, losses incurred by new business during the first six years of operation may be carried forward indefinitely.

In terms of accounting methods, only very small businesses may use the cash basis; others must use the accrual method. The existence of effective accounting records has assumed special tax significance in that only then may certain privileges be availed of, such as those regarding investment allowances and the unlimited carry forward permitted new enterprises.

(h) *The relevance of residency.*—The basic jurisdictional principle regarding residents (corporate or individual, and without regard to nationality) calls for inclusion in gross income of income derived from without as well as that derived from within the country. But this notion has been restricted in sweep, except for interest, dividends, and royalties, by unilateral provisions designed to avoid double taxation. Roughly speaking, these serve to exempt foreign income arising from personal labor performed abroad or that derived from commercial and industrial activities performed by a foreign permanent establishment, provided the income was *subject* to tax in the foreign country. That the foreign income did not actually suffer a foreign tax is not decisive; it may have been sufficiently low to be covered by exemptions. The pivotal question is whether it was subject to a foreign tax. Exempt income will be aggregated, however, with a taxpayer's domestic income in determining the place his domestic income fits into the progressive rate brackets. Corporations will suffer very little from this requirement, for, practically speaking, a flat corporate rate is used in the Netherlands.

In contrast to the sweeping basic premise regarding residents, a nonresident is generally subject to the Netherlands income tax only with reference to income deemed to have its source there.

In the case of a business, this embraces profits derived from an agricultural enterprise in the Netherlands, or those from a non-

⁴⁷ This amount will probably be increased to \$1,961 (Fl. 7450).

agricultural enterprise if derived through a permanent establishment or regular representative located there. Included also in this latter category is any profit from the sale of shares in a Dutch corporation, provided the shareholder had a so-called "considerable interest" therein.

With reference to personal services, a nonresident must include income from employment in the Netherlands, including that derived from service as a manager or as one of the directors of a Dutch corporation and any periodic payments received from a Dutch governmental unit or from the State Civil Pension Fund. Income from the independent exercise of a liberal profession will be reached, however, only if carried on through a permanent establishment located there.

A nonresident's investment income will also be reached to the extent it consists of (1) interest on debts secured by a mortgage on Netherlands realty, (2) a share in the profits of a business or profession which has its seat in the Netherlands, and (3) dividends and interest from a Dutch corporation but only if the nonresident has a so-called "considerable interest" and the securities or obligations do not constitute a part of the nonresident's business property. While securities and obligations owned by a nonresident corporation will always be deemed to be a part of that corporation's business property, any immunity thereby achieved will be lost if in fact the securities and obligations belong to a Netherlands permanent establishment of the foreign corporation. Even where this is not the case, a nonresident corporation will always suffer a flat 15% withholding tax (*Dividendbelasting*) on dividends received, except where provision is made otherwise by treaty.

Except for the above differences relating to source, the question of whether a particular gain is income is determined for a nonresident in accordance with the same principles which govern residents. Illustrative are the various principles relating to capital gains.

The jurisdictional standards relating to the separate net wealth tax on individuals have a practical effect similar to that associated with the income tax. The initial premise is that the net wealth tax applies to all of a resident's property, without regard to location. But again, unilateral provisions and double taxation treaties restrict that general principle so that in many cases only property deemed situated in the Netherlands is reached. While, as expected, nonresidents suffer this tax with respect to real estate situated in the

Netherlands and businesses carried on there, the securities which they hold in Dutch corporations are free of the tax.

(i) *The cost of retaining versus the cost of distributing profits to an American enterprise.*—Because of the cumulative effect of two circumstances, direct taxes imposed by the Netherlands will be the same whether an American enterprise operates its facility there as a branch (permanent establishment) or through a foreign subsidiary. First, in contrast to the arrangement in Belgium, a corporation's own direct taxes in the Netherlands will remain the same whether or not its profits are distributed. The Netherlands does not even impose a penalty tax on so-called unreasonable accumulations of earnings and profits. Second, dividends paid to an American parent by a Netherlands subsidiary are freed from the withholding tax otherwise applied in the Netherlands to dividends received by certain nonresidents, such as parent corporations domiciled in Belgium, Germany, and Luxembourg.

The primary exception to the rule, that the Netherlands will impose the same total direct taxes on branch and subsidiary operations, involves the circumstance where the American parent's investment is represented in part by loans to a subsidiary (other than loans secured by immovable property). Advances to a branch operation will not be treated, of course, as loans. But a subsidiary will be allowed to deduct interest paid, up to a reasonable amount, as an expense. The interest received by the parent company—wherever situated—will not, on the other hand, be subjected to a Netherlands tax.

If a subsidiary desires to retain its profits to facilitate expansion, the profit can be capitalized through issuance of a stock dividend. Dividends of this sort, received by parent companies in America, France, Italy, or the Netherlands, will not be subjected to tax. But if any part of such dividend is paid to individual stockholders in the Netherlands, a tax will be imposed by reference to the nominal or par value of the dividend shares. And if such a dividend is paid to parent companies in Belgium, Germany, or Luxembourg, the same rate as that applicable to ordinary dividends will be assessed, 15%.

(j) *Disposition of an enterprise.*—A sale by a corporation of all of its assets is a taxable event, gain, if any, being the difference between the adjusted basis of the assets and the amount realized. And if the corporation is then liquidated, the stockholders will be

deemed to have received a taxable dividend to the extent the amount received exceeds the paid-in capital.

Generally, too, a merger involves a taxable transaction to the corporation, gain again being the difference between the adjusted basis of the corporate assets and their real value. Only if a guarantee is made that the tax will be paid later on (e.g., where the newly formed corporation is actually to be liquidated) will gain not be recognized at the point of the merger.

SUBSECTION 2. OTHER NETHERLANDS TAXES

(a) *Turnover taxes and excise duties.*—The Netherlands employ multiple stage turnover taxes, the normal rate of 5% being exacted on each transfer of goods which may take place in the course of developing a finished product. Generally speaking, this means that an integrated company which converts basic raw materials into a finished product has an advantage over those which depend upon suppliers to do part of the processing. One transfer, however, is exempt—that from a retailer to an individual consumer. Transfers directly from a manufacturer to a consumer do not enjoy this exemption; a reduced rate of 4% is applied, however, on the premise that this rate will produce the same amount of tax as that which would have been produced by a 5% tax if the goods had been transferred to a retailer. This premise assumes that the circumvented transfer to a retailer would have been at a smaller price, allowing room for a 20% retail mark-up. On the other hand, it ignores the fact that there is also a .75% tax on transfers by one dealer of finished goods (e.g., a wholesaler) to another dealer.

Because the turnover tax was designed to be an *internal consumption* tax, the regular 5% rate, and sometimes an even higher rate, is imposed at the point of importation.⁴⁸ Export transactions, on the other hand, are exempt, and this exemption is coupled with a refund of tax levied at earlier stages, the amount of the refund normally being a percentage fixed by Royal Decree. The effect of this overall pattern is to deprive imports of any advantage over domestically produced items, and to make the latter, if exported, competitive on the world market.

A number of basic necessities, such as bread, milk, etc., are immune from the turnover tax. On the other hand, at the manufacturing level, certain luxury and semi-luxury goods suffer a turnover

⁴⁸ This matter, insofar as it relates to exports from the United States to the Netherlands, is more fully dealt with in PART II, *infra*.

tax in excess of the normal rate. Moreover, special excise duties are levied on the production or import of such products as beer, wine, tobacco, etc. Finally, services, including those rendered by a business representative, are taxed at 4%.

(b) *Land tax and registration duty on transfers of realty.*—The previously described net wealth tax on individuals was an indirect device designed to give preferential treatment to earned income, such as that from employment. In contrast to its base—the net value of one's equity, a separate land tax is imposed on the rental value of all improved and unimproved real estate situated in the Netherlands. The rental values utilized fall far short of the current market, however, for they are still based on estimates made in the 19th century.

In addition to the foregoing, there is a registration duty on transfers of real estate for money or money's worth, the rate being 5%. While donative transfers are free of this exaction, they are subject to the gift tax described below.

(c) *Succession duty and gift tax.*—The succession duty is not levied on the estate as such, but on individual acquisitions by heirs and legatees of those who die domiciled in the Netherlands. The rate is progressive depending on the relationship of the parties as well as on the value acquired.

A nonresident decedent's property situated in the Netherlands is free of the succession duty except with respect to real estate on which a flat 6% rate is levied.

Provisions covering the succession duty also include a gift tax on *inter vivos* transfers. The structure and rates of this tax correspond to those associated with the succession duty.

(d) *Miscellaneous taxes.*—Other taxes include one imposed annually on motor vehicles, the assessment being based on weight, and stamp duties levied on diverse types of instruments and documents.

PART II. OVERALL TAX EFFECTS RE DIRECT EXPORTS AND SIMPLE LICENSING ARRANGEMENTS

SECTION A. INTRODUCTION

Many American manufacturers first introduced their products to foreign countries through sales to New York purchasing offices of foreign import companies. Thereafter, direct orders from overseas were received from others who had seen the product in foreign markets. Further exploitation may then have been attempted through arrangements entered into with foreign independent commission agents or brokers. As a substitute for the latter, or to complement their activities, promotional representatives may have been sent from the United States to one or more countries, and these may or may not have opened display offices.

The discussion which follows deals first with the overall tax effects of these *simple* export arrangements. Comparative tax effects in the Common Market countries will be integrated with the domestic tax implications. Put off for discussion in PART III, however, are the more sophisticated sales arrangements, involving use of a foreign sales office with general contracting powers or creation of a foreign sales subsidiary.

Eventually, and for a variety of reasons, an American exporter may conclude that those products destined for foreign markets should actually be manufactured abroad, in whole or in part. The prime motive may run all the way from avoidance of freight costs to avoidance of customs duties and minimization of foreign turnover taxes—all of which would affect prices. An alternative to construction of its own facilities in a member nation is the opportunity to conclude a licensing arrangement with an established European firm. Such an arrangement might actually be entered into for the purpose of stimulating export sales, rather than as a complete substitute for them. The aim, for example, may be to provide a better and more certain outlet for special parts or components to be manufactured in, and exported from, the United States, the ultimate product to be finished by the licensee.

Again, inadequacy of capital or an unwillingness to risk available

capital in a foreign country may be the prime motive for entering into a royalty-producing licensing arrangement instead of constructing a foreign facility. It might be further contemplated that the American company, in consideration of additional periodic payments, would keep the licensee abreast of any newly acquired technical knowledge and methods, instructing the licensee's employees in such "know-how" to the extent necessary.

Discussion of licensing arrangements in this PART will be limited, as in the case of exports, to simple arrangements, involving taxpayers who seek to avoid significant activity on foreign soil. PART III, *infra*, will take account of the more complex and sometimes more advantageous tax effects which follow when a license and "know-how" agreement are complemented by creation of a foreign subsidiary.

SECTION B. COMPARISON OF FOREIGN TAXES ON DIRECT EXPORTS

(a) *Foreign income taxes*.—Unilateral statutory provisions preceded bilateral conventions in fixing the extent to which European income taxes would reach profits made by a nonresident, such as an American enterprise, on exports into Common Market countries. The statutes of three member nations (Germany, Luxembourg, and the Netherlands) specifically provide that such profits are reached by their respective income taxes *only* if made through a "permanent establishment" located there. While the domestic laws of the other three members have been construed with more or less similar effect, treaties with a like thrust—between the United States and five of the members¹—actually do more than codify in permanent form this established principle. The treaties serve the additional function of establishing bilaterally acceptable standards with respect to the meaning of "permanent establishment" in, *inter alia*, export settings.

On the one hand, the definitional aspects of the term, "permanent establishment," had already been resolved in some measure in most countries. That expression was thought in general to relate to a fixed place utilized by the nonresident in carrying out his profitable activities. But not all subscribed to so limited a view.² Moreover,

¹ A tax treaty has not yet been concluded with the sixth country, Luxembourg.

² For instance, according to the national laws of Italy and France, the standard was satisfied whenever a nonresident person regularly or habitually performed activities which constituted a complete cycle of business.

there were important "grey" areas, just as there are instances where one cannot be sure under American law whether a given nonresident will be deemed to be "engaged in a trade or business in the United States." Though the language in the treaties does not provide a ready answer to all export situations, the provisions do constitute an improved point of departure in resolving definitional difficulties.

According to all five treaties, the mere fact that an American enterprise handles its European sales through a bona fide independent commission agent or broker, acting in his regular capacity as such, will not, standing alone, lead to the taxation of its export profits. Indeed, all five recognize that an American enterprise's own employed representative in the Common Market will not himself be deemed a permanent establishment, though engaged in sales promotion work, provided he (1) does not have, nor habitually exercises, "general authority to negotiate and conclude contracts on behalf of" the American enterprise, *and* (2) does not have "control over a stock of merchandise from which he regularly fills orders on behalf of such enterprise."

Four of the treaties do not specifically deal with the case where a mere sales promotion representative also has a small stock to accommodate emergency cases or for display purposes. Such a person would not be "regularly" filling orders; nor would he necessarily have, or be "habitually" exercising, general authority to negotiate and conclude contracts on behalf of the American enterprise. These considerations were sufficiently impressive to lead the American government to publish an interpretation favorable in the reverse setting to some nonresidents who send promotional representatives to the United States.³ Foreign governments, however,

³ United States regulations pertaining to its treaty with Belgium are perhaps the most informative with respect to the American interpretation of treaties falling in this group. T.D. 6160, Section 504.104(b)(8)(ii) provides: "If the enterprise has an agent in the United States who has power to contract on its behalf, but only at fixed prices and under conditions determined by the enterprise, it does not thereby necessarily have a permanent establishment in the United States. The mere fact that an agent of a Belgian enterprise—assuming he has no general authority to negotiate and conclude contracts on behalf of his principal—maintains samples, or occasionally fills orders from incidental stocks of goods maintained, in the United States does not of itself mean that the enterprise has a permanent establishment in the United States. The mere fact that salesmen, employees of a Belgian enterprise, promote the sale of their employer's products in the United States or that a Belgian enterprise transacts business in the United States by means of mail order activities does not mean that the enterprise has a permanent establishment in the United States." Section 504.105(b) adds: "Similarly, if during the taxable year, the enterprise were to secure orders in the United States for such merchandise through its sales agents whose sole function in the United States is sales promotion, the orders being transmitted to Belgium for acceptance, then the profits arising from such sales would not be includible in gross income and would be

seldom publish general interpretations. At an extreme point, it must also be remembered that three of the above mentioned four treaties do go on specifically to state that a "warehouse" does constitute a permanent establishment, and the other would probably subsume that characterization under the shotgun expression, "or other fixed place of business." Thus, in the case of a stock of goods kept on hand for emergencies, at some point one will encounter the supplementary question: How large a stock can be on hand, and how frequently can resort be made to it, before the storage arrangement will be characterized as a warehouse? In this setting, not much comfort can be derived from the further fact that two treaties (Germany and Italy) specifically exclude the "casual and *temporary* use of mere storage facilities" from the definition of a permanent establishment.

The fifth treaty, one with Germany, stands alone in specifically mentioning the matter of displays. But there, displays are first conjunctively associated with a sales office in a proscription to the effect that a "permanent display and sales office" will be deemed a permanent establishment. It then goes on to say that a warehouse maintained "for convenience of delivery and not for purposes of display shall not of itself constitute a permanent establishment."⁴

In the case of most countries, one may be more secure in relying on information obtained from tax authorities in the country concerned or, in the case of emergency stocks, arrange to have such exports remain under customs seal in that country. While published rules do not exist even with reference to the immunity of this practice, it is not believed that such stocks would be deemed a permanent establishment. Moreover, with reference to all exported items, this arrangement provides added advantages in connection with the matter of turnover taxes, a matter discussed under the next subtopic.

Finally reference should be made to PART III, *infra*, for con-

exempt from United States tax." United States regulations relating to the treaty with the Netherlands also adopt a liberal interpretation for the benefit of foreigners, providing as follows: "The mere fact that an agent (assuming he has no general authority to contract on behalf of his employer or principal) maintains samples or occasionally fills orders from incidental stocks of goods maintained in the United States will not constitute a permanent establishment within the United States." T.D. 5778, § 7.853(a). Regulations relating to the treaty with France are somewhat similar: "However, the mere fact that a commission agent or broker through whom a French enterprise carries on business in the United States maintains a small stock of goods in the United States from which occasional orders are filled shall not be construed as meaning that such enterprise has a permanent establishment in the United States." T.D. 5499, § 7.413(a).

⁴ Art. II(1)(c).

sideration of the way income taxes are affected by various organizational arrangements, should an American enterprise desire to create a permanent establishment in a member nation in connection with export operations.

(b) *Comparative effect of Common Market turnover taxes and excises on direct American exports into a member nation.*—The turnover tax patterns in the Common Market countries are so complicated and varied as to preclude doing anything more here than provide a general comparative orientation of the way in which they might affect direct American exports.

The country-by-country survey in PART I indicated that each Common Market nation exempts its own exports from its turnover tax. Each does, however, impose its tax on imports. Otherwise imported items would not suffer the same tax burden as domestically produced items designed for consumption within the country. In keeping with the logic of this theme, a particular import may enjoy an exemption or suffer luxury or semi-luxury rates if domestically produced competitive items are so treated. The classification of luxury items varies, of course, from country to country.

In comparing the turnover taxes of member nations, it will be recalled that in four countries (France, Germany, Luxembourg, and the Netherlands), the effective rates of the local turnover tax are slightly higher than the stated rates, for the tax is imposed on a sales price which includes the tax itself. The cumulative character of turnover taxes in all countries but France has also given rise to further differentials regarding the turnover tax on imports. A *single* transfer rate, if imposed on certain imported items, would not be sufficient to equalize the tax burden with that borne by domestically produced equivalents which have gone through more than one taxable transfer in the course of development. To compensate for the difference, four countries (Belgium, Germany, Italy, and the Netherlands) may impose on certain imports a rate which is greater than that imposed on a single transfer of a domestically produced item.⁵ Since the difficulty stems from the multiple stage character of turnover taxes, the amount of increase is frequently lower for various raw materials than for finished or semi-finished products. These increased rates are usually imposed irrespective of the country of origin, the one exception relating to an immunity from such increase of items imported into Belgium from Luxembourg.

⁵ Luxembourg may also apply increased rates, but rules pertaining to such have not yet been issued.

Table II A reflects the normal stated and effective rates, the stated and effective rates for luxuries, and the maximum by which these rates might be increased on certain imports over that rate borne by a single transfer of domestically produced equivalents.

TABLE II A

	<i>Normal Stated Rate</i>	<i>Normal Effective Rate</i>	<i>Luxury Stated Rate</i>	<i>Luxury Effective Rate</i>	<i>Max. Amt. by Which Other Rates May Be Increased</i>
Belgium	5%	5%	11 or 13%	11 or 13%	10% ^a
France	20%	25%	25%	33.33%	—
Germany	4%	4.17%	4%	4.17%	2%
Italy	3.3%	3.3%	8.3%	8.3%	—
Luxembourg	2%	2.04%	2%	2.04% ^a	—
Netherlands	5%	5.26%	18-20%	22-25% ⁷	7%

The foregoing rates are normally imposed on the same value as that used for the purpose of customs' duties adjusted for certain matters, the most important of which is usually the amount of import taxes themselves.

An American enterprise which makes direct exports to customers in member nations should take account of the possibility that turnover taxes might be levied more than once before his product reaches the ultimate consumer.

The first such possibility may be affected by the way in which he designs the sale. Except in Belgium and Italy, one turnover tax *may* be levied by reference to the act of import and another on the delivery to the customer if the sale, as defined under the member nation's law, is deemed to take place there. For example, delivery under reservation of title until payment is effected may give rise to such multiple taxation. Again, in the Netherlands, title to goods shipped from New York via public transport is normally deemed to pass upon delivery to the customer, not upon delivery to the transport agency. In that country, however, multiple taxation can be avoided in two instances. First, tax free delivery in a sea-port is permitted, but only in the case of staple commodities. Second, with respect to other goods, multiple turnover taxation can be avoided by keeping the goods under customs bond until delivery can be effected. The double tax problem is much less acute in Germany;

^a *Ibid.*

⁷ The stated rate for cars is 7%, yielding an effective rate of 7.5%.

⁸ In practice, the increase does not exceed 6%.

actual delivery, as such, is less significant there in determining passage of title. For example, title to goods shipped from New York via public transport, if addressed to the purchaser, is deemed to pass upon delivery to the transport agency.

In those circumstances where multiple turnover taxes are applied, first on import and then again on actual delivery, the same rates are usually applied to the two events except in the case of the Netherlands where the wholesaler's rate of .75% is imposed on one of the two events. Indeed, a second tax will not be imposed there if the delivery is to a person who buys the goods for his private consumption. In the event both circumstances are taxed in France, a credit in the amount of the first tax will be allowed against the second tax, for in effect France quite generally taxes only the value added, not the value transferred.

The discussion above involved the possibility of multiple turnover taxation in effecting delivery to an American enterprise's own customer. In analyzing its competitive position, the American enterprise must also take account of the fact that its own customer will also suffer a turnover tax, though perhaps at a different rate, if it holds the goods for re-sale, for that tax will affect the ultimate price paid by the consumer. Table II B compares the rates which would normally be applied to an importer's re-sale.

TABLE II B

<i>Country</i>	<i>Rate If Re-sale Is to Person Who Buys Other Than for His Private Consumption</i>	<i>Rate If Re-sale Is to a Person Who Buys for His Private Consumption</i>
Belgium	5%	0
France	20% (There is a credit for tax previously paid)	20% (Credit is also allowed here for tax previously paid)
Germany	1% (Wholesaler's rate)	4%
Italy	3.3%	0
Luxembourg	.5% (Wholesaler's rate)	2%
Netherlands	.75% (Wholesaler's rate)	0

In Germany and the Netherlands, the foregoing tax can be avoided in the case of staple commodities which enjoy immunity at the point of delivery in sea-ports and for the first delivery outside these sea-ports. In Belgium and Italy, multiple taxation can be mitigated for a number of different items with respect to which *one* tax, though usually higher than normal, covers all stages from the manufacturer or importer to the consumer.

As indicated in the country-by-country survey in PART I, each member nation imposes certain excise duties, usually at very high rates, on specific goods, as distinguished from turnover taxes which, in general, apply to transfers of all goods. It is not possible within the confines of this study to list all of the goods subject to such excises nor all of the rates which are constantly changing. Examples include alcoholic beverages, sugar, tobacco, and mineral oils. Italy, more than others, impose excises on a very long list, and these are equally applicable to imports.

SECTION C. AMERICAN TAXES RE EXPORTS DIRECT TO FOREIGN CUSTOMERS

(a) *Introduction.*—The effect of the federal income tax on export profits derived by an American enterprise from direct sales to foreign customers turns on two questions. The first involves the extent to which such profits are includible in gross income. The second relates to the other side of the ledger: To what extent is a deduction or credit allowed for any foreign taxes paid with respect to such transactions?

The separate discussion below of these two questions indicates that the American income tax affects a simple export arrangement in a manner quite similar to that associated with domestic sales. A third sub-topic goes on to examine the *overall competitive* tax position of an American exporter, due account being given to the tax patterns of the more significant federal excise taxes.

(b) *Gross income as affected by export profits from sales direct to foreign customers.*—Congress has acknowledged that profit from a *foreign* sale of personal property produced in the United States is derived partly from sources within, and partly from sources without, the United States.⁹ But this is primarily significant only to nonresident aliens and *foreign* corporations. Beginning with the first income tax act passed pursuant to the Sixteenth

⁹ I.R.C., § 863(b).

Amendment, Congress has required *domestic* corporations to include in their gross all income without regard to the source from which it was derived.¹⁰

This assertion of world-wide jurisdiction, applicable also to individual citizens and residents, was sustained by the Supreme Court in the face of contentions of unconstitutional discrimination by reference to the fact that nonresident aliens and foreign corporations were required *only* to include that income which was derived from sources *within* the United States.¹¹

As a result of that determination, a domestic corporation's gross income from direct exports will not be affected by the question of whether title and the risk of ownership changes in the United States or in Europe. Its entire profit will be includible in either event. As a practical matter, however, this need mean only that the *manufacturing* profit will be within the reach of the Internal Revenue Service. All or a portion of the remaining profit associated with the distribution process—getting the product into the hands of the *ultimate* foreign consumer—may be free of the American income tax and be subject only to what may be smaller direct taxes of a foreign country, thus reducing the total amount of direct taxes which the whole process must absorb.

The extent to which the distribution profit will be immune from the federal tax depends on the choice of media through which distribution is to be handled. Illustratively, sales to an unrelated *foreign* incorporated wholesale export house with a purchasing office in New York, or to a foreign import house with a purchasing office in a Common Market country, would confine the American vendor to the manufacturing profit. Even if both wholesalers consummated their purchases in the United States, the distribution profit could be placed beyond the range of the federal treasury. Since a foreign corporation's profit is includible in American gross income only to the extent it is derived from sources within the United States, the two wholesalers could avail themselves of the further statutory provision which treats profit derived from the purchase of personal property within, and its sale without, the United States as derived *entirely* from sources without this country.¹² It would be essential

¹⁰ Rev. Act of 1913, § G(a), now I.R.C., § 61.

¹¹ *National Paper and Type Company v. Bowers*, 266 U.S. 373, 45 S. Ct. 133 (1924). A like result was reached in the case of the foreign income of a citizen resident abroad, *Cook v. Tait*, 265 U.S. 47, 44 S. Ct. 444 (1924), and of an alien resident in the United States. *Bowring v. Bowers*, (2d Cir. 1928) 24 F. (2d) 918, cert. den., 277 U.S. 608, 48 S. Ct. 603 (1928).

¹² I.R.C., § 862(a)(6).

to immunity, of course, that the wholesalers' dispositions take place outside this country.¹³

A somewhat similar effect would be accomplished, but by virtue of different principles, if the sale to the *ultimate* foreign consumer is effected by the American vendor through a foreign *independent* commission agent, as distinguished from a foreign merchant. While the American vendor's *gross* would be fully includible in its gross income, the sales commission would be deductible as a selling expense.¹⁴ And this is so though the foreign agent's distributing commission is free of American tax, suffering instead the direct taxes of the appropriate foreign country.

For at least a period of time, it is even possible for the American manufacturer to immunize the distribution profit without dividing it with strangers. It could create its own *foreign* subsidiary. The tax advantages associated with this more dramatic penetration into a foreign country are considered, however, in PART III *infra*. With reference to the American manufacturer who is not yet quite ready to become so involved in foreign soil, it is important to note here, however, that the prime tax advantages associated with a *foreign* sales subsidiary are not available to an ordinary¹⁵ domestic subsidiary which might be created to handle direct export sales. This latter arrangement would serve only to divide between two domestic corporations that gross income which would otherwise be enjoyed by the parent. The one advantage in this relates to the possibility of creating a second exemption from surtax, the subsidiary's first \$25,000 of taxable income being subjected only to the normal tax rate of 30%.¹⁶ Assuming the parent company is in the 52% bracket, the consequent 22% yearly saving on the first \$25,000 (\$5,500) will be more than offset, however, by the tax on inter-corporate dividends¹⁷ if the subsidiary's pre-tax sales profit approximates \$135,000 or more. At that point, its after-tax income of approximately

¹³ For federal purposes, generally the place where the benefits and burdens of ownership pass fixes the place of sale. I.T. Regs., § 1.861-6; *U.S. v. Balanovski*, (2d Cir. 1956) 236 F. (2d) 298, cert. den., 352 U.S. 968, 77 S. Ct. 357 (1957); *Commissioner v. East Coast Oil Co., S.A.*, (5th Cir. 1936) 85 F. (2d) 322, cert. den., 299 U.S. 608, 57 S. Ct. 234 (1936).

¹⁴ I.R.C., § 162.

¹⁵ The relevance of the proposed Foreign Investment Incentive Tax Bill of 1960 (the so-called Boggs Bill) is mentioned in PART VI, *infra*.

¹⁶ I.R.C., § 11. Even this advantage might be lost under some circumstances, by reference to I.R.C., §§ 1551, 269, or 61. E.g., see *James Realty Co. v. United States*, (D.C. Minn. 1959) 59-2 USTC para. 9660; *Aldon Homes, Inc.*, 33 T.C. No. 65 (1959).

¹⁷ Inter-corporate dividends are deductible by the recipient only to the extent of 85%. I.R.C., § 243.

\$70,000¹⁸ would suffer an inter-corporate dividend tax equal to the earlier saving. This tax on inter-corporate dividends can be avoided only if the parent files a consolidated return which carries with it loss of the added exemption otherwise enjoyed by the subsidiary and an additional 2% charge on the total income derived from domestic as well as export sales.

To avoid the difficulties just mentioned, a parent company might seek to confine the domestic subsidiary's profits by setting unrealistic limitations on its sales commissions or by charging unrealistically high prices for items purchased by the subsidiary for re-sale. Obviously the Internal Revenue Service does not, and cannot, officially approve such practices whatever a given revenue agent may allow in a specific case. The Code contemplates that transactions between parent and subsidiary will conform to commercial practices followed by those who bargain at arm's length.¹⁹

(c) *Deductions or credits for foreign taxes re exports direct to foreign customers.*—Congress began in 1913 to take account of all foreign taxes paid by an incorporated American enterprise, the arrangement coinciding with that traditionally associated with state and local taxes.²⁰ A deduction from gross income was allowed in arriving at the net to which the American rates were to be applied. In that day, income taxes imposed by states were more or less *de minimus*.²¹ World War I costs, however, led foreign countries almost immediately to increase substantially their income and excess profits taxes. Congressional accommodation of those charges only by way of a deduction meant that the federal government absorbed only that percentage of the foreign tax equal to a domestic taxpayer's American rate. The enterprise itself had to absorb the balance. In 1918, for the asserted purpose of reducing the "very severe burden" which followed the double taxation of foreign earned income, Congress created a credit, allowing American enterprises to elect to offset the domestic tax itself with any foreign "*income, war profits, or excess profits taxes*" imposed on income

¹⁸ On a gross income of \$135,000, the subsidiary would pay 30% on the first \$25,000 (\$7,500) and 52% on \$110,000 (\$57,200), a total tax of \$64,700 leaving \$70,300 available for dividends.

¹⁹ I.R.C., § 482.

²⁰ Rev. Act of 1913, § G(b) [5] (fourth). Individuals were not allowed this benefit until 1916. Rev. Act of 1916, § 5(a). Cf. Rev. Act of 1913, § (B) [7] (third). Both are now accommodated by I.R.C., § 164.

²¹ The first state income tax was not passed in the United States until 1911, and by 1919 the total yield in all states approximated only \$50,000,000. HELLERSTEIN, *STATE AND LOCAL TAXATION* 7 (1953).

derived "from sources within such [foreign] country."²² Of course, provision was made to prevent an electing taxpayer from doubling up by deducting from gross income any tax for which the credit arrangement had been elected.²³ While the privilege to elect a credit was later extended to other types of taxes, this was so only where the other tax was imposed in lieu of an income, war profits, or excess profits tax otherwise generally imposed.²⁴

Since an American enterprise engaged only in direct exports to customers in the Common Market is not likely to incur foreign taxes of a type which satisfy the credit provision, the refinements limiting the credit are considered in PART III, *infra*. That such taxes are not likely to be encountered in the circumstance under consideration stems from the fact, as noted in Section B *supra*, that the United States has a bilateral tax treaty with all member nations except Luxembourg. And these conventions free "industrial and/or commercial profits" of American enterprises from foreign *income* taxes except in the instance where a "permanent establishment" is maintained abroad.

Under this standard, an American enterprise engaged only in direct export sales could retain immunity even if the sales arrangement called for the burdens and benefits of ownership to pass in Europe, rather than in the United States. As a business matter, however, this may be neither practicable nor desirable. Moreover, as noted in Section B, *supra*, the effect may be to multiply the number of times the foreign country's turnover tax will be applied, once at the point of import and again on delivery. While such taxes would be deductible in computing gross income for American purposes, the credit provision would not apply²⁵ with the consequence that the manufacturer's competitive position might be prejudiced.

Providing for the benefits and burdens of ownership to pass in the United States may in one circumstance, on the other hand, entrap an American company into double taxation of its export profits. Suppose that the American company, while operating under this arrangement, sends a promotional representative to a Common Market country intending to so limit his function as to preclude the foreign government from asserting that a permanent establishment

²² H. Rep. No. 767, 65th Cong., 2d Sess. 11 (1918); Rev. Act of 1918, §§ 222(a)(1) and 238(a)(1), now, as modified, I.R.C., § 901 et seq. (Italics added.)

²³ Rev. Act of 1918, §§ 214(a)(3) and 234(a)(3), now I.R.C., § 164(b)(6).

²⁴ Rev. Act of 1942, § 158(f), now I.R.C., § 903.

²⁵ E.g., Eitingon-Schild Co., Inc. and Subsidiaries, 21 B.T.A. 1163 (1931). Inapplicability of the credit provision to turnover taxes is more fully discussed in Section D, *infra*, in the setting of royalties received from licensing arrangements.

has been created there. Later, to accommodate business requirements, the promotional representative informally assumes added responsibilities to a point where the foreign government, while acknowledging that the matter falls into the "grey" area, asserts, nevertheless, that a permanent establishment has been created. It might go on to assert that profits from the export sales are attributable to that establishment even though the benefits and burdens of ownership passed in the United States. The United States, on the other hand, might deny that a permanent establishment was created and deny that any credit is allowable against the American tax for the asserted foreign income tax. As a general proposition, bilateral tax treaties require the United States to grant a credit only to the extent provided for in the Internal Revenue Code.²⁶ And in an equally general sense, credit for foreign income taxes is allowed only where the taxpayer derived income from a foreign source.²⁷ The American government might contend that passage of the benefits and burdens of ownership in the United States meant that the export profit had its source in this country,²⁸ rendering inapplicable the credit arrangement. While diplomatic channels might be available in any effort to conform the foreign country's interpretation of the so-called "grey area," this type of remedy may be small comfort to a taxpayer whose foreign activities—as viewed by the foreign government—have slipped just over the "permanent establishment" line.

(d) *Comparing the competitive tax positions of American exporters with that of other exporters, and with producers in a Common Market country.*—The foregoing discussion indicates that an American enterprise may export items direct to customers in a member nation without incurring any *income* tax liability under the latter's laws, provided only that sales are not handled through its own "permanent establishment" located there. The shape of the internal laws of the member nations is such that the same result would generally follow even in the absence of bilateral tax treaties with the United States.²⁹ It follows from this that competitive enterprises in other exporting countries can also avoid Common

²⁶ The usual practice in the treaties is first to freeze the American credit provisions as they existed at the time the treaty goes into effect. It is then provided that this shall not restrict allowance of any credit otherwise allowed by the national laws of the contrasting states. See, e.g., the treaty with Belgium, Articles XII and XX.

²⁷ I.R.C., § 904. This is discussed more fully in PART III.

²⁸ See note 13, *supra*.

²⁹ However, see note 2, *supra*.

Market income taxes even though the exporting country does not have bilateral tax treaties with the member nations. On this score, the only difference between the position of such an exporting enterprise and one in America relates to slight variations which may exist between the way "permanent establishment" is defined under the national laws of member nations and the way it is defined in the American bilateral tax treaties.³⁰ Generally, however, these differences are not likely to have great practical significance. For example, where the transactions are handled through an importer, both exporters may want to deal only with an independent firm in order to avoid any contention that they maintain a taxable permanent establishment in the member nation.

Nor, with respect to Common Market *turnover* taxes—standing alone, will the competitive *tax* position of American exporters differ from that of other outsiders who export into the Common Market. Turnover taxes of member nations do not generally differ by reference to the origin of imported items.

It is the relationship of the outsiders' *domestic* income tax systems to their *own* respective turnover tax systems that controls the competitive tax position *inter se*. Where the former taxes are high, the latter will be relatively lower, and vice versa. Accordingly, an exporter in an *outside* country with relatively low income taxes and relatively high turnover taxes which are refunded at export will enjoy a competitive tax advantage over another outsider from a country with an opposite tax pattern, and vice versa. As between outsiders from different countries, Common Market taxes will have a neutral effect; neither outsider will be subject to the income taxes of member nations and both will suffer the same Common Market turnover taxes.

The same *domestic* relationships generally control the competitive *tax* positions of exporters from outside the Common Market with those from within with respect to *exports* to *other* member nations. Finally, an outside exporter in a country with a relative low income tax and relatively high turnover taxes which are refunded at export will enjoy a competitive *tax* advantage over a *local* producer in a given member nation which, relatively speaking, has an opposite tax pattern. Both will suffer approximately the same turnover taxes—hypothetically the low one imposed by the member nation, and by hypothesis the local producer is subject to the greater income tax.

³⁰ Cf., e.g., note 2, *supra*, with the discussion of the treaty provisions in Section B.

The foregoing problem is not peculiar to comparisons between outside exporters and producers within the Common Market. It exists within the Common Market itself. Indeed, from the beginning of "Benelux" and the Coal and Steel Community, tax experts have worked diligently, without much practical success, to resolve the difficulties growing out of the differentials.

While American industry is burdened with a relatively high income tax and with some non-refundable indirect taxes, at least with reference to certain rather widely applied excises it does enjoy a position generally comparable to competitors situated in countries which immunize exports from turnover taxes and refund those previously paid. In this connection, the United States imposes a manufacturers' excise tax on the sale of a variety of items, including, e.g., automobiles, appliances, refrigerators, musical instruments, phonographs, records, radios, television sets, photographic apparatus, light bulbs, pens and mechanical pencils, lighters, and business machines.³¹ The most typical rate is 10%. Until 1958, the practice followed under the then existing law with regard to these items³² allowed a manufacturer to make a tax-free sale, regardless of the number of subsequent intermediate purchasers,³³ as long as he had advance knowledge that the article was destined for exportation before any other use was to be made of it. In one sense, however, the tax was only suspended; the manufacturer had to obtain proof within 6 months of his shipment or sale (whichever was earlier) that the item had actually been exported.³⁴ Many manufacturers were concerned with problems associated with proof of eventual exportation in that instance where several intermediate purchasers were involved.³⁵ Accordingly, beginning with the revision in 1958, manufacturers have been permitted in the export setting to make tax-free sales only where the sale itself was "for export, or for resale by the purchaser to a second purchaser for export . . ." prior to any other use.³⁶ This was coupled with another provision bearing on the instance where tax had to be charged because there would be more than one intermediate purchaser; a refund, the benefit of which would actually be enjoyed ultimately by the exporter, could be obtained in that instance, provided the necessary

³¹ I.R.C., Chapter 32, § 4061 et seq.

³² Tobacco products are dealt with separately in I.R.C., § 5704(b).

³³ H. Rep. No. 2596, 85th Cong., 2d Sess. 7 (1958).

³⁴ This goes back to an interpretation under the old code (I.R.C. (1939), § 2705) in *Treas. Reg. 46* (1940), § 316.25.

³⁵ H. Rep. No. 481, 85th Cong., 1st Sess. 30 (1957).

³⁶ I.R.C., § 4221(a)(2).

conditions were satisfied.³⁷ One of these conditions traces back to an interpretative position taken by the government under earlier law, to the effect that sales could be made tax free or refund obtained only if the manufacturer had *advance* notice that the product he was selling was ultimately destined for export prior to any other use.³⁸ To some, this was an objectionable limitation.³⁹ Others thought it served a useful purpose. For example, automobile manufacturers urged that only through this advance notice requirement would they be in a position to see that an exported automobile was properly equipped for driving in the foreign country.⁴⁰ In the end, the limitation in question survived the revision of 1958 as to a host of articles, though not all. The rule continues to apply, e.g., in the case of automobiles, refrigeration equipment, appliances, radio and television sets, and phonographs.⁴¹

In spite of the relatively favorable treatment of exports under the manufacturers' excise tax, the over-all competitive *tax* position of American exporters will be less favorable than that of an exporter from a low income tax country unless the latter's turnover tax provides an inadequate rebate system for exports. Because items competitive with American products might come from any one of a hundred countries, it is not possible to lay down fixed rules. At the moment, the American exporter can do little more than determine whether his product would be competitive price-wise under the existing price structure within a given member nation. No advantage would be derived from shipping goods to one country for re-shipment to a member nation. While the first country's turnover taxes could be avoided, the turnover taxes of the country of destination would apply just as in the case of direct exports to that country.

SECTION D. FOREIGN AND DOMESTIC TAXES RE SIMPLE LICENSING ARRANGEMENTS

(a) *Introductory note.*—For any one of the reasons indicated in the Introduction to this PART, an American enterprise may eventually choose to have its product manufactured, in whole or in part, in one or more of the Common Market countries. Simple licensing arrangements and "know-how" agreements with estab-

³⁷ I.R.C., § 6416.

³⁸ H. Rep. No. 2596, 85th Cong., 2d Sess. 7 (1958) and H. Rep. No. 481, 85th Cong., 1st Sess. 72 (1957).

³⁹ See H. Rep. No. 481, 85th Cong., 1st Sess. 72 (1957).

⁴⁰ S. Rep. No. 2090, 85th Cong., 2d Sess. 75 (1958).

⁴¹ The limitation survives as to manufacturers' excises imposed by I.R.C., §§ 4061(a), 4111, 4121, 4141, and 4201. See H. Rep. No. 2596, 85th Cong., 2d Sess. 5, 8 (1958).

lished foreign firms, the over-all tax effects of which are considered below, may be entered into as a substitute for establishment by the American company of its own facility abroad. Later, in PART III, account will be taken of the additional over-all tax advantages which may follow when such arrangements are complemented for one or more reasons by creation of a foreign subsidiary.

(b) *Comparison of foreign income taxes on royalties from licenses.*—If the American enterprise licenses its patent to an independent European firm, the latter may treat royalties paid as a business expense fully deductible from gross income in computing its own income tax. For purposes of the German enterprise or business tax, however, only one-half the amount is deductible. Again, with reference to the income tax properly so-called, in the case of dependent corporate licensees (a subsidiary or majority-owned company), such royalties are deductible only to the extent they are fair in amount and do not represent a “hidden” distribution of profits.

In the absence of a bilateral tax treaty, all member nations except the Netherlands would compensate themselves for the loss of revenue flowing from the deduction by treating royalties paid to nonresidents as taxable income to them. The Netherlands does not impose a tax on royalties paid a nonresident except where the latter has a Dutch permanent establishment. With respect to the other member nations, again in the absence of a treaty, in all but one a special income tax rate would actually be applied, and then—except in Germany—only to the *net* royalty which remains after payment of a turnover tax the rates of which are discussed in the next sub-topic. The special income tax rates which would be applied to the net amount follows:

Belgium	18%
France	24%
Germany	25%
Italy	23.62% on $\frac{2}{3}$ of the gross amount
Luxembourg	12%

The United States has concluded tax treaties with all member nations except Luxembourg. These, like similar treaties between other countries, generally exempt from the income tax otherwise imposed by the licensee's country any royalties paid to a nonresident American licensor in consideration, for example, of “the right to use copyrights, patents, secret processes and formulae, trademarks,

and other analogous rights.”⁴² In effect then, the American enterprise’s royalties would generally be subject to a member nation’s special rates only where the licensee is a Luxembourg firm.

The immunity otherwise enjoyed is subject, however, to an important limitation, i.e., that the American firm does not maintain a permanent establishment in the member nation in question. The consequence which would follow from maintenance of such an establishment is still open to dispute. One possibility is that the royalty will be subject to the special rates set forth above. The other is that the royalties will be deemed to be a part of the income of the permanent establishment and taxed according to the rates applicable to its income. The difficulty arises from the fact that all five treaties literally exempt only those American firms “not having a permanent establishment” in the member nation. Discussions are still being carried on with the aim of identifying which result should follow under various circumstances. At the moment there seems to be a tendency to treat such royalties as part of a permanent establishment’s income only if conclusion of the licensing agreement can properly be considered a part of the permanent establishment’s business activities.

A somewhat different interpretative difficulty which may arise involves possible differences between royalties properly so-called and additional payments for providing continuous technical assistance. At some point, the technical assistance to be rendered may include an element of *service*, as distinguished from an act of *communicating* in a *practical* way the nature of the “right” granted—for the *use* of which “right” the consideration is aptly characterized as royalty. The foreign income tax problem will not be complicated, of course, where the additional service, if any, is performed within the United States. In such case, compensation for the service would have its source in the United States. But a problem may arise where instruction, etc., is to take place abroad. Even in this case, however, it must be remembered that normally the treaties do immunize payments for the right to use secret processes and formulae as well as more concrete intangibles such as a patent. And meaningful communication of the “right” is indispensable, i.e., part and parcel, to its use. Sterile written instructions may well fall far short of communicating the exact nature of the right granted. In the reverse

⁴² All of the treaties except that with Germany use language almost identical to that quoted. Two of the treaties project the immunity only to one other case; those with Belgium and France go on to provide that the term royalties shall be deemed to include rentals in respect to motion picture films. The other three also include rentals and like payments for the use of industrial, commercial, and scientific equipment,

situation, where an American company was the licensee and was to be given instruction in the United States with reference to the foreign licensor's "know-how," the line of reasoning just indicated led the Internal Revenue Service to react as follows:

The essence of the contract is the making available to the domestic corporation the technical knowledge, methods, experience, that is, the "know-how" of the foreign corporation. While manufacturing "know-how" is of a nonpatentable nature, it is something that its possessor can grant to another for a consideration. The right to use such "know-how" is not materially different from the right to use trade-marks, secret processes and formulae, and, if the right thereto is granted as part of a licensing agreement, it becomes, in effect, an integral part of the bundle of rights acquired under such agreement.

The payments made under the contract are applicable both to the specific rights therein granted, that is, the right to use the "know-how," and to services performed abroad in instructing and training the employees or technicians of the domestic corporation. Such payments should therefore be allocated between the license to use the "know-how" and the personal services. Since the personal services have only nominal value apart from the license to use such "know-how," all but a nominal sum should be allocated to the license.⁴³

As indicated in the next sub-topic, one Common Market country has indicated, at least for purposes of its *turnover* tax, that consideration paid for those practical steps essential to a meaningful communication and practical utilization of the right granted will be deemed royalty. Notice was given, however, that accessory operations going beyond that line would not be so classified.⁴⁴

(c) *Comparison of foreign turnover taxes on royalties from licenses.*—All Common Market countries treat the benefit rendered by the licensor as a service to the licensee, with the consequence that the gross amount of the royalty is subjected to a turnover tax. The rates vary as follows.

Belgium	—5%	Italy	—3%
France	—8.5%	Luxembourg	—2%
Germany	—4%	Netherlands	—4%

While the French rate is higher than that of others, it is important to note that under an agreement between France and the

⁴³ Rev. Rul. 55-17, C.B. 1955-1, 388 at 389.

⁴⁴ Procès-Verbal with France, effective February 15, 1956, CCH Tax Treaties, para. 2876.

United States, an American licensor (company or individual) will be completely exempt if the licensor can qualify as the inventor.⁴⁵ It is also significant that a similar agreement exists between France and several other countries (Austria, Belgium, Denmark, Germany, Netherlands, Norway, Sweden, Switzerland, and the United Kingdom). Under the agreements, where an American firm transfers its patent to a holding company in, for example, Switzerland, that holding company can obtain the exemption if the American parent itself can qualify as the inventor. The extension of immunity in this case is subject, however, to approval of the French tax administration.

It may well be that Common Market countries will contend for purposes of their turnover taxes that additional payments literally earmarked as consideration for furnishing "know-how" should also be treated as royalties. The reasoning which might justify such a contention, and the limitations applicable thereto, were indicated in the preceding sub-topic. In this connection, France, on agreeing to immunize royalties paid an American inventor, adopted the following line:

The exemption will cover not only the royalties collected in consideration for the licensing of the right to utilization of the inventions mentioned above (paragraph 1) but also the royalties paid for the whole group of steps necessary for the practical utilization of the invention (know-how), for the protection of the invention and for the technical assistance which is indispensable to the exploitation of the invention (for example, making available to the French licensee the American licensor's technicians in connection with getting the invention started; supervision of the putting into place of the installations necessary for the exploitation of this invention and the utilization of blueprints; instruction of the licensee; supervision of the initial manufacturing results). On the other hand, this exemption will not apply to royalties relating to accessory operations, such as the hiring of labor, the furnishing of supplies, advertising, carried out on French territory.⁴⁶

(d) American tax treatment of foreign earned royalties.

—While the Internal Revenue Code attributes to a *foreign* source

⁴⁵ This arrangement was consummated by an exchange of letters between the Treasury and the French Minister of Finance. Prior thereto, and for a long period, France had not imposed its turnover tax on royalties paid to nonresident licensors. A decision by the French government to overturn this earlier administrative practice was followed immediately by protests from American licensors. The above mentioned exchange of letters grew out of the negotiations undertaken by the two governments.

⁴⁶ Procès-Verbal, effective February 15, 1956, CCH Tax Treaties, para. 2876.

any royalties or rentals received by an American company for the right to use its patents, secret processes, etc., *outside* the United States,⁴⁷ such income—like other income from a foreign source—must be included in its gross.⁴⁸ Deductions which may then be taken in arriving at taxable income will be comparable to those enjoyed with reference to a like amount of domestic income. For example, in determining the amount of costs amortizable over the useful life of a patent, the question of whether such costs will include research and developmental expenditures will turn on whether the taxpayer invoked the right under § 174 of the Code to deduct research and developmental costs in the year incurred.

Since five of the six Common Market nations are precluded by treaty from imposing their respective income taxes on royalties received by American companies which do not maintain permanent establishments abroad, only those received from Luxembourg would require and enjoy the credit against American tax which § 901 of the Code grants for any “income, war profits, or excess profits taxes paid or accrued during the taxable year to any foreign country. . . .”

Computation of the amount of credit allowable in this latter instance may be more complicated than usual if the licensing agreement also requires the American company, for additional stated periodic consideration, to provide intermittent instruction in the United States for employees of the foreign licensee with reference to the licensor’s “know-how.” While details regarding the computation of the credit are covered in PART III, *infra*, it should be noted here that credit is generally allowed only for that tax attributable to income which had its source in the foreign country.⁴⁹ On this point, Luxembourg might contend that the *entire* consideration constituted a royalty for the right to use, all of which had its source there, and that the United States was simply the place where the nature of the right granted was communicated in practical terms. In a somewhat related setting, the United States acknowledged that “the personal services have only nominal value apart from the license to use such ‘know-how,’ ” but went on to indicate that the “nominal sum” which should be attributed to the service rendered would have its source in the United States,⁵⁰ the balance being allocated to the license and having its source abroad.⁵¹

⁴⁷ I.R.C., § 862(a)(4).

⁴⁸ I.R.C., § 61.

⁴⁹ I.R.C., § 904.

⁵⁰ See I.R.C., § 861(a)(3).

⁵¹ Rev. Rul. 55-17, C.B. 1955-1, 388; cf. *International Standard Electric Corp. v.*

With reference to *turnover* taxes, it is most unlikely that the previously quoted language from § 901 of the Code would authorize any credit for taxes of this type which five of the six countries would always impose on royalties and which France, the sixth, would assess except in the instance where the licensor or its affiliate can qualify as the inventor.⁵² Admittedly the impact of such taxes, when imposed on royalties, is equivalent to a tax on gross income. But turnover taxes, have an even more general sweep, embracing also *gross receipts* from sales, etc. An over-all perspective regarding an earlier French turnover tax which had been applied to American exports led the Board of Tax Appeals to conclude that it was something other than a profits tax. It was deemed an "excise tax on the privilege of carrying on in France businesses of the kinds enumerated . . . ," and this was thought to be none the less true though in reaching gross sales of services the tax was measured by the "equivalent of gross income or profits."⁵³ This same over-all perspective constituted one reason why the Internal Revenue Service more recently ruled against allowance of a credit for the German turnover tax imposed on royalties received by an American firm not having a permanent establishment there.⁵⁴ The Service, however, had to go on to deal with the question of whether a credit was allowable under another provision in the Code which authorized such in the case of *any* foreign tax paid "in lieu of a tax on income, war profits, or excess profits otherwise generally imposed by . . . [such] foreign country. . . ." ⁵⁵ The taxpayer claimed that it was enough under this language that the royalty would suffer *only* a turnover tax, having been freed by a bilateral tax treaty from the reach of a German income tax which was otherwise generally imposed. The Service concluded, however, that the turnover tax was not a *quid pro quo* for the relief granted against the German income tax. The latter relief was simply a concession to avoid double income taxation. Consequently, the turnover tax did not satisfy the alternative requirement that it be "in lieu of" an income tax.

Commissioner of Internal Revenue, (2d Cir. 1944) 144 F. (2d) 487, cert. den., 323 U.S. 803, 65 S. Ct. 560 (1945).

⁵² For details regarding such qualification and the meaning of inventor in a Procès-Verbal made effective as of February 15, 1956, see CCH Tax Treaties, para. 2876 et seq.

⁵³ Eittingon-Schild Co., Inc. and Subsidiaries, 21 B.T.A. 1163, 1174 (1931).

⁵⁴ Rev. Rul. 56-635, C.B. 1956-2, 501.

⁵⁵ I.R.C., § 903.

PART III. COMPARATIVE TAX EFFECTS OF CONDUCTING INTERNATIONAL TRADE THROUGH FACILITIES IN THE COMMON MARKET

SECTION A. INTRODUCTION

(a) *Alternative business arrangements.*—An American enterprise which has been shipping goods to Europe in response to orders received directly from its European customers may believe that something more than a promotional representative is needed there. From a business standpoint, apart from tax considerations, it may favor establishment of a permanent sales office. Or tariff walls, together with transportation and comparative production costs, may suggest that its goods would be more competitive if manufactured or assembled there. Rather than enter into the previously discussed licensing arrangement with an existing European firm, it may prefer to establish its own foreign manufacturing facility.

Whether it chooses to establish a sales office or a manufacturing facility, it must also decide whether to operate through a permanent establishment, in the nature of a branch, or transact its affairs through a foreign subsidiary. It must also choose the country in which to base its operations and decide whether and how its foreign business can be best extended into other member nations. Tax considerations may contribute, of course, to the shape of the final plan.

In order to facilitate comparisons, discussion in this PART proceeds first on the assumption that a facility is to be established in only one country and that trade will be confined within its boundaries. Data regarding the tax loads in each of the six countries will be compared in the settings of a branch operation and an incorporated foreign subsidiary, and then integrated with American tax implications.

Thereafter the discussion will assume that trade is also to be carried on with one or more other member nations. It is in this circumstance that the tax implications arising from exports by the one foreign facility to the other member nations are compared

with those which would arise from creation of yet another facility. That second facility might be either a subsidiary or a branch of the first. Or it might be a sister branch or subsidiary directly controlled by the American parent. And if it takes on the form of a sister subsidiary, the parent may want to create a foreign holding company to hold the shares of the two different subsidiaries. The tax implications of all of these possibilities will be considered in turn on a comparative basis, i.e., concurrently in the setting of each member nation. Some attention will even be given to the way tax costs may be affected if a holding company is established in a so-called "tax haven" outside the Common Market.

Finally, the relative tax costs of exporting goods from within the Common Market to non-member nations will be compared with the establishment in those non-member nations of permanent establishments or subsidiaries owned or controlled by Common Market corporations.

(b) Need for caution in assessing comparative data; also the varying roles of direct and indirect taxes compared to national product.—One must be careful not to place too much stress on the type of comparative data which can be reflected in this type of study. In this connection, assume that a company has a *gross* profit of \$1,000,000. The ultimate taxable profit to which comparisons must be geared may be quite different depending on whether it is located in one country or another. Depreciation arrangements, stock valuation methods, special investment allowances, and loss carry-over privileges are only illustrations of matters about which there may be differences from country to country. Again, the tax on distributed profits may differ from that on undistributed profits. There are also varying property taxes, the impact of which in terms of a percentage of income will differ depending on the ratio between profits and the invested capital of the particular business. The danger of being misled through overemphasis on the comparative data set forth in this PART will be less, however, in the case of those who have studied the country-by-country survey which appears in PART I.

Comparative data regarding the total tax load borne by all taxpayers in each country can be equally misleading. Much depends on the way tax revenues are used by the different governments. Illustratively, part of these may be used by a given country to finance social security, whereas another supposedly lower tax country may finance old age benefits by direct contributions from those

covered, and this may affect wage rates. Again, a country with high taxes may provide an excellent system of railroads and highways, whereas a low tax country may have an inferior transportation system complemented by higher costs in doing business. Indeed, in assessing the comparative data which appears in Table III A regarding the total tax loads borne in various countries in terms of a percentage of national product, account must even be taken of differences which may exist among the countries in calculating the national product, the income, and the net wealth of its people.

TABLE III A

TOTAL TAX BURDEN ¹					
Country		Gross Natl. Product per Person	Tax Revenue as a % of Gross Natl. Product	% of Total Taxes De- rived from Income and Net Wealth Taxes	% of Total Taxes Derived from Other Sources
Belgium	B. Fr.	\$1,196 59,780 }	17%	47%	53%
France	Fr. Fr.	\$ 931 465,400 }	18%	40%	60%
Germany	DM	\$ 969 4,070 }	20%	53%	47%
Italy	Lire	\$ 519 322,340 }	17%	30%	70%
Luxembourg	B. Fr.	\$1,388 69,410 }	20%	59%	41%
Netherlands	Fl.	\$ 845 3,210 }	23%	60%	40%

In terms of a percentage of gross national product, total revenues derived by the federal, state, and local governments in the United States would align it alongside the Netherlands, the latter being the Common Market country the taxes of which absorb the highest percentage of its product. In this connection, however, it must be remembered that the gross national product of the United States, per person, is approximately 85% more than the amount produced by the most productive Common Market country.

The federal government's tax collections are also about 2½

¹ MONTHLY BULLETIN OF STATISTICS OF THE UNITED NATIONS, Central Bureau of Statistics, The Hague.

times that of states and local units. While it relies far more heavily on the income tax than do the Common Market countries, the combined yield of this source to all three units would approximate the same percentage of total tax revenues as is derived from this source by the Netherlands, Luxembourg, and Germany. Table III B reflects data of a character comparable to that presented above with reference to the Common Market countries.

TABLE III B

TOTAL TAX BURDEN—UNITED STATES

	<i>Gross Natl. Product per Person</i>	<i>Tax Revenue as a % of Gross Natl. Product</i>	<i>% of Total Taxes Derived From:</i>		
			<i>Income Taxes</i>	<i>Property Taxes</i>	<i>Other Sources</i>
U.S. Federal govt.	\$2,580 ²	17.6% ³	73.70% ⁵	—	26.30% ⁹
State and local	—	6.3% ⁴	10.65% ⁶	46 % ⁸	43.35% ¹⁰
Combined Federal, State and local	—	24. %	57. % ⁷	10.9%	32.10% ¹¹

² This figure was arrived at by dividing the Federal Reserve Bulletin's estimate of the 1959 gross national product (\$479,500,000,000) by the World Almanac's estimated population for the United States in 1959 (177,399,000). Fed. Res. Bull. (March, 1960) p. 328 and the World Almanac for 1960 (New York World Telegram and The Sun) p. 257.

³ The ANNUAL REPORT, COMMISSIONER OF INTERNAL REVENUE (1959), p. 3, indicated that federal tax collections in fiscal 1959 amounted to \$79,797,973,000. See note 2, *supra*, for the gross national product.

⁴ The Wall Street Journal, April 13, 1960, indicated that state and local tax collections in 1959 approximated \$29,000,000,000. For the gross national product, see note 2, *supra*.

⁵ See note, 3, *supra*.

⁶ This is the figure for the year 1956. The percentage is based on data appearing in MICHIGAN TAX STUDY, LEGISLATIVE COMMITTEE, HOUSE OF REPRESENTATIVES (1958) pp. 40 and 41. It is not likely that the percentage has changed substantially since that date.

⁷ This involves a combination of the 1959 figures for the federal government and the 1956 figures for state and local governments. It is believed, however, that the figure would be substantially correct today.

⁸ This percentage is based on data appearing in MICHIGAN TAX STUDY, LEGISLATIVE COMMITTEE, HOUSE OF REPRESENTATIVES (1958) p. 39.

⁹ Excise taxes, including those on alcohol, tobacco, retailers, manufacturers, estates, and gifts yielded 15.1% of total federal tax collections. The balance (11.2%) came from employment taxes designed mainly to accommodate old age benefits and disability insurance.

¹⁰ Of this, 2.4% is derived from "business taxes" of which some resemble an income tax in one degree or another.

¹¹ This combines federal figures for fiscal 1959 with state and local figures for 1956. However, it is believed that the figure would be approximately correct today.

SECTION B. COMPARING FOREIGN TAX COSTS OF A PERMANENT ESTABLISHMENT WITH A SUBSIDIARY SERVICING ONE MEMBER NATION

SUBSECTION 1. COMPARING FOREIGN DIRECT TAXES

(a) *Comparing the role of treaties re permanent establishments and subsidiaries: In general.*—As previously noted, the United States has concluded tax treaties with all Common Market countries except Luxembourg with which a treaty is under negotiation. These are intended to limit tax liability to a greater degree than would otherwise be the case under national laws. This is particularly so in the cases of Italy and France. According to the national laws of both countries, a nonresident person becomes liable to tax if he regularly and habitually performs activities which constitute a complete cycle of business. Under the tax treaties with them, as with others, the nonresident individual or corporation is only taxable if a “permanent establishment” is maintained there. National laws relating to jurisdiction remain important in such cases only where the treaty creates an ambiguity regarding the meaning of “permanent establishment” in a given setting. While the treaties generally go beyond national law in sharpening the definition of a “permanent establishment,” a given nation may be inclined to resort to its own historic definition in the event of an ambiguity in the relevant treaty.

The effect of tax treaties on subsidiary companies is quite different in character. Generally, the treaties exclude subsidiaries, *as such*, from the definition of a permanent establishment. Under the national laws of all countries, profits of a corporation, domestic to them, are taxed twice, once to the corporation and then in one way or another to the stockholders on receipt of dividends. The latter tax is usually withheld at the source, at least in part. The tax treaties are designed either to avoid, as in the case of the Netherlands, or mitigate, as in the case of France or Germany, the second tax, i.e., the one which would otherwise fall on dividends received by the American parent company. It is possible for a subsidiary to occupy a dual role, i.e., be fully taxable on its own profits and also serve as a “permanent establishment” for the parent. For example, a manufacturing subsidiary located in a member nation might also serve as sales agent for products manufactured by the parent company in the States. The subsidiary’s own manu-

facturing profits and agency fees would be fully taxable to it by the member nation, while the American parent company would be liable for tax on the profit derived from sales which it made through its permanent agent, the subsidiary.

(b) *Comparing direct taxes of member nations on "permanent establishments."*—Under the tax treaties, an American enterprise would not generally be taxable on commercial or industrial profits derived from trading in a member nation unless it transacts business through a "permanent establishment." While the enumeration of facilities covered is not always the same, most treaties define this to include a branch, factory, office, warehouse, workshop, mine, stone quarry, or permanent display and sales office, and all close by referring to the most common underlying denominator, "or other *fixed place of business*."

In only two significant instances does the concept "permanent establishment" go beyond that common characteristic.

The first of these instances was discussed earlier in PART II where it was noted that all treaties include an agent who has, and habitually exercises, a general authority to negotiate and conclude contracts on behalf of the American enterprise or who has a stock of merchandise from which he regularly fills orders on behalf of the enterprise. However, the concept does not include business conducted through a bona fide independent commission agent, broker, or custodian acting in the ordinary course of his business as such, nor does it include a fixed place used exclusively for the purchase of goods.

The second instance where a treaty goes beyond the concept of a fixed place of business involves the arrangement with Germany regarding construction projects. Under Germany's national law, the notion of "permanent establishment" includes a construction or assembly project the duration of which exceeds or is likely to exceed 6 months. The treaty serves only to extend the dateline to 12 months. While the national laws of the Netherlands are similar to those in Germany, the treaty between the former and the United States does not characterize a construction project, standing alone, as a permanent establishment with the consequence that the matter of timing in that setting is now irrelevant. Luxembourg poses the third alternative. Its national laws are similar to those in the Netherlands and Germany. Since the United States has not yet concluded a treaty with Luxembourg, a construction or assembly project the duration of which exceeds 6 months will

be deemed a permanent establishment, the profits of which will be taxed by Luxembourg.

While a permanent establishment is considered separate from the American enterprise for the purpose of determining how much profit was earned by the facility, that calculated profit is deemed to be owned by the American enterprise as it is earned and is, therefore, taxable to it *without regard to the question of whether the profit has been transferred to the States*.

Calculation of the amount of profit which is properly attributable to the permanent establishment, and thus taxable by a member nation, is not always easy. Where an American enterprise's facilities in the United States carry on business with a European permanent establishment which in turn carries on business activity in a member nation, the total profit must be divided between the two, for only that properly attributable to the permanent establishment is taxable by the member nation. Most treaties face up to this problem by attributing to the permanent establishment the industrial or commercial profits which it might be expected to derive if it were an independent enterprise engaged in the same or similar activities under the same or similar conditions and dealing at arm's length with the enterprise of which it is a permanent establishment. In keeping with this principle, expenses reasonably allocable to the permanent establishment, including a proper share of executive or general administrative expenses, are deductible by it in determining its taxable profit.

Set forth in Table III C is a comparison of the direct taxes which each member nation would impose on a permanent establishment.

(c) *Comparing direct taxes of member nations on subsidiary arrangements.*—An American enterprise can create a subsidiary, i.e., an independent entity, domiciled in any one of the member nations. All would permit its organization as a limited liability company or, except in the Netherlands, as a private company (a *société à responsabilité limitée* in Belgium, France, or Luxembourg; a *società a responsabilità limitata* in Italy; a *Gesellschaft mit beschränkter Haftung, GmbH*, in Germany).

The subsidiary would be taxed by the appropriate member nation in the manner described in the country-by-country survey set forth in PART I and later summarized on a comparative basis in this PART. Bilateral tax treaties with the United States would have no effect on that tax. At most, the treaties only influence the

TABLE III C

Country	Corporation Income Tax	Business Tax	Approximate Percentage of Profits Absorbed by Income and Business Tax	Property Tax (% of Profit Depends on Ratio Between Profits and Value of Property)	Excess Profit Tax	Approximate Percentage of Profits Absorbed by Income and Excess Profits Tax
Belgium	30% ¹³		30% ¹³			
France	50%		50% ¹⁴			
Germany	49%	1. Deductible for corp. income tax purposes. 2. Calculation: a. Basic rate of 5% of profit, multiplied by coefficients fixed by municipalities averaging 2.7; plus b. Basic rate of .2% on value of property multiplied by same municipal coefficients; plus c. Basic rate of .2% on wages paid, municipal coefficients averaging 9. ¹⁰	57% ¹⁵ (Including property factor of business tax)	1% on net value		
Italy	31.23% (Maximum)		See last column	.75% on net value	15% on profits in excess of 6% on value of property 1. 31.23% on profits up to 6% on value of property; and 2. 46.23% on profits in excess of 6% on value of property	

Luxembourg	20% where profit under \$8,000 30% where profit under \$20,000 with marginal relief to first \$8,000 40% where profit over \$20,000 with marginal relief for first \$20,000	1. Deductible for corp. income tax purposes. 2. Calculation: a. Basic rate of 4% of profit, multiplied by coefficients fixed by municipalities averaging 2.1; plus b. Basic rate of .2% on value of property, multiplied by same coefficients; plus c. Basic rate of .2% on wages paid, multiplied by coefficients from 5 to 6.	45% ¹⁷	.5% on net value
Netherlands	47% (If profits do not exceed \$13,200 the rate goes down to a low of 44%)		47%	

¹² This is the effective rate, account having been taken of the fact that the income tax of one year is a deduction in computing taxable profits of the next year.

¹³ In addition, there are small municipal taxes which are levied at variable rates, depending on the amount of energy used, number of employees, etc.

¹⁴ The franchise tax (*contribution des patentes*) has not been included. It is a small variable burden, depending on the place of business, kind of industry, number of employees, rental value, etc.

¹⁵ This percentage is very rough. It would be slightly higher, e.g., if all three factors of the deductible business tax applied significantly to a given enterprise.

¹⁶ This last factor is not applied in all parts of Germany. Where it is not, the average coefficients relating to the other two factors are usually higher than would otherwise be the case, except in small municipalities.

¹⁷ This approximation will vary, of course, with variations in the amount of the deductible business tax.

member nation's treatment of dividends and interest paid by the subsidiary to the American parent company.

Conceptually speaking, the two primary differences between utilization by an American enterprise of a foreign permanent establishment in the nature of a branch and a foreign subsidiary appear most dramatically in that circumstance where all profits of a new foreign facility are to be retained abroad either to discharge indebtedness created in connection with establishment of the facility or to finance further expansion. In the case of a permanent establishment, the Common Market country would include the entire profit, as earned, in the gross income of the American company. The United States would do likewise, though according to the discussion in Section C, *infra*, a credit for the foreign income tax would serve to cushion or completely neutralize the effect of an otherwise double tax.

While the profit of a subsidiary would also be taxed in full by the member nation, in the absence of a distribution the American parent company would not be subjected to the member nation's dividend tax, if any, nor would it immediately suffer an American tax. Any attempt to compare the income *and* property taxes which would be exacted from such a subsidiary by each member nation can be quite misleading, for the reasons outlined in the Introduction to this PART. This difficulty is minimized, but not eliminated, if the comparison is directed to a common fact situation. For example, while an assumption that the subsidiary earned \$400,000 (before direct taxes) on its assumed net worth of \$4,000,000 (10%)¹⁸ accommodates itself to progressive rate variations or to the fact that a given member nation might be exacting its toll through two different income taxes with varying rates, such an assumed situation ignores differences which may actually exist among member nations with regard to depreciation and other deductions which may be taken in arriving at taxable profit. It is also difficult to take into account the deductible direct trade or enterprise taxes which, as discussed in PART I, are levied in all countries, except the Netherlands, and are imposed primarily by reference to profits and net wealth, except in Italy where it constitutes a surcharge only on the national income tax. Nevertheless, for illustrative purposes, the income and property taxes which would be exacted from such a subsidiary by the member nations are

¹⁸ If the ratio is higher than 10%, the tax burden will be relatively lower in Germany and Luxembourg and higher in Italy. If the percentage is less than 10%, the reverse would be true.

compared in Table III D. Insofar as practicable, the figures reflecting those taxes have also been adjusted to take account of the more significant corporate enterprise taxes.

TABLE III D

	<i>Income and Property Taxes Payable by the Subsidiary</i> ¹⁹	<i>Profits Remaining for Expansion (apart from that retained as a consequence of initial or other special investment deductions)</i>
Belgium ²⁰	27.47%	72.53%
France ²¹	50%	50%
Germany ²²	69.95%	30.05%
Italy ²³	44.67%	55.33%
Luxembourg ²⁴	51.67%	48.33%
Netherlands ²⁵	47%	53%

¹⁹ The figures set forth here and the formulae which appear in notes 20 through 25, 30, and 31, *infra*, are taken, with the consent of the author and publisher, from INTERNATIONAL BUREAU OF FISCAL DOCUMENTATION, COMPANY TAXATION IN WESTERN EUROPE (R. Mees & Zoonen, Rotterdam, 1959).

²⁰ From PART I, it will be recalled that a Belgian corporation pays the *Taxe Professionnelle* on undistributed profits, a National Crisis Tax on distributed profits, the *Taxe Professionnelle* on that part of the profits used to pay the National Crisis Tax, and that the *Taxe Professionnelle* is allowed as a deduction in determining taxable profits.

The formula for the computation of the tax is as follows: $TP = d + p(P - TP - e)$.

The symbols in that formula carry the following meaning: TP is the *Taxe Professionnelle*; d represents the TP which is levied before reaching the rate applying to the next bracket; p is the percentage applying to the next bracket and this is reached after deduction of the amount on which d was calculated, and is represented by e. The amount on which p is levied is thus equal to the profit (P) less the *Taxe Professionnelle* (TP), this being a deductible item, and less e.

By reference to the rate brackets set forth in PART I, Section A, a tentative tax can be computed as follows:

First bracket	\$3,000 × 25%	\$750
Second bracket	7,000 × 30%	2,100
Third bracket	10,000 × 35%	3,500
Fourth bracket	180,000 × 37½%	67,500
		<u>\$73,850</u>

Top bracket: Over \$200,000 at 40%

Under the previously stated formula, the value of d is \$73,850, p is 40%, and e is \$200,000. The formula can then be applied as follows:

$$TP = \$73,850 + \frac{40}{100} (400,000 - TP - 200,000)$$

$$TP = \$153,850 - 0.4 TP$$

$$TP = \$109,893. (27.47\% \text{ of the pre-tax profit of } \$400,000; \text{ leaves } \$290,107 \text{ or } 72.53\% \text{ in the corporation.})$$

²¹ The only French tax on corporations is the *Impôt sur les Sociétés* of 50% on total income, whether or not distributed.

²² The German formula is as complicated as that used in determining the Belgian tax.

(Footnote continued on next page.)

While the comparisons just drawn assumed that none of the profits would be currently distributed in the form of dividends, some interest on indebtedness running to the parent company may have been paid.

(Footnote continued.)

Under the *Körperschaftsteuer*, a German corporation is subject to a 51% tax on retained earnings and a 15% tax on distributed profits. The German *Gewerbesteuer* or enterprise tax (3 factor: profits, net wealth, and payroll) is subject to a multiplication factor fixed by each municipality. The formula below takes account only of net wealth and profits, and at maximum rates. Where a municipality does not use the payroll factor, rates regarding the other two factors may be somewhat higher. The enterprise tax is a deductible item. Finally, the *Vermögensteuer* or net worth tax of 1% is also imposed.

With K, G, and V representing the three above named taxes, and y the total tax, the basic formula would be $y = K + G + V$. That formula becomes the following:

$$(1) G = \frac{6}{1000} NW + \frac{15}{100} (P - G) \text{ when } NW = \text{net worth and } P = \text{profit}$$

$$G = \frac{6}{1000} \times \$4,000,000 + \frac{15}{100} (\$400,000 - G) =$$

$$G = 24,000 + 60,000 - \frac{15}{100} G$$

$$G = \$73,043$$

$$(2) V = 1\% \text{ of } NW = \$40,000.$$

$$(3) K = \frac{51}{100} (P - G) = \frac{51}{100} (400,000 - 73,043) = \$166,748$$

$$y = 166,748 + 73,043 + 40,000 = \$279,791 \text{ or } 69.95\%$$

$$\text{There remains in the corporation } \$120,209 \text{ or } 30.05\%$$

$$\underline{\$400,000} \text{ or } \underline{100.00\%}$$

²³ The Italian formula must accommodate the *Imposta sui redditi di Ricchezza Mobile* (R.M.), and the *Imposta sulle Società* (I.S.) on profit and net worth. If y equals the total tax, the formula would be $y = \text{R.M.} + \text{I.S.}$ or:

$$(1) \text{R.M.} = 27.85 \times \$6,450 + 31.23\% \times \$393,550 = \$124,701$$

$$(2) \text{I.S.} = .75\% \times \$4,000,000 + 15\% (P - \frac{6}{1000} NW) = 54,000$$

$$(3) \text{Tax Amount (44.675\% of pre-tax profit)} \quad \underline{\$178,701}$$

$$(4) \text{Profit remaining in the corporation (55.325\%)} \quad \underline{\$221,299}$$

²⁴ Luxembourg levies the following taxes on corporations: *Impôt sur le revenu des collectivités* (IC); *Impôt sur la fortune* (IF); and *Impôt commercial* or Business Tax (BT) which includes, at maximum rates, a .4% tax on net worth (NW) and an 8% tax on profit (P). Thus the basic formula could be applied as follows:

$$(1) y = \text{BT} + \text{IF} + \text{IC}$$

$$(2) \text{BT} = \frac{4}{1000} NW + \frac{8}{100} (P - \text{BT}) = \frac{4}{1000} \times 4,000,000 + \frac{8}{100} (400,000 - \text{BT})$$

$$\text{BT} = 16,000 + 32,000 - 0.08 \text{ BT.}$$

$$\text{BT} = \quad \quad \quad \$44,444$$

$$(3) \text{IF} = \frac{5}{1000} NW = \frac{5}{1000} \times 4,000,000 = \$20,000$$

$$(4) \text{IC} = 40\% \text{ of } (P - \text{BT}) = 0.4(400,000 - 44,444) = \$142,222$$

$$\underline{\$206,666}$$

$$\text{Total tax amounts to } \underline{\$206,666} \text{ or } \underline{51.67\%}$$

$$\text{There remains in the corporation } \underline{\$193,334} \text{ or } \underline{48.33\%}$$

$$\underline{\$400,000} \quad \underline{100.00\%}$$

²⁵ The Dutch tax is always 47% of total income. But see PART VI, note 1, *infra*, with respect to pending legislation calling for reformation of the Dutch tax system.

In all countries, such interest would be deductible in computing the subsidiary's profit, provided the amount is fair and reasonable and does not represent a disguised dividend.²⁶ In the absence of a bilateral treaty, the national laws of three of the six member countries would make the nonresident parent company liable for tax on the interest received. Germany, the Netherlands, and in some cases France would immunize the parent company, provided the loan was not secured by a mortgage on real property.²⁷ While the immunity in France does not cover interest on *bonds*, by treaty, both France and Belgium have agreed to place a ceiling on the rate which would otherwise be applied to any interest taxed under their respective national laws. Table III E indicates the rate under national laws as well as ceilings pursuant to treaty arrangements, if any.

TABLE III E

	<i>National Law Rate</i>	<i>Ceiling Fixed by Treaty</i> ²⁸
Belgium	18%, or 12.2% if tax is paid by the debtor	15%
France	Bonds generally, 24% Industrial bonds, 12%	15%
Germany	0	Exemption
Italy	25.18%	No limitation
Luxembourg	5%	No treaty
Netherlands	0	0 ²⁹

The foreign direct taxes associated with the previously described subsidiary arrangement may change in two respects when the subsidiary reaches the point where some of its current profits can be distributed as dividends, say 40% of that which remains after allowance for the subsidiary's own foreign direct taxes.

²⁶ In France the deduction is limited by a ceiling; interest is deductible only to the extent the loan does not exceed half of the corporation's capital. Moreover, in Germany, interest on long term debts is not deductible for purposes of the business tax.

²⁷ Immunity under the national laws of the Netherlands would not extend to interest received by one owning 25% or more of the stock of the company except where the shares are considered business property of the stockholder. The latter exception would always apply in the case of a parent corporation.

²⁸ The treaty provisions relating to interest are limited to cases where the American enterprise does not have a permanent establishment in the Common Market nation.

²⁹ The treaty with the Netherlands does not limit taxability of interest if the creditor owns more than 50% of the voting stock in the debtor corporation. However, under its national laws, the Netherlands does not normally reach interest received by a nonresident shareholder where the shares constitute a part of the latter's business property. In such case, interest is taxed only if the loan is secured by a mortgage on real property.

The first additional tax implication involves the member nation's treatment of the American parent company with regard to the dividend received by it. In the absence of a tax treaty, dividends, as distinguished from interest, would have been reached by the national laws of all member nations except Italy. However, by treaty three of the other five countries have agreed to reduce their withholding tax on dividends to a percentage below that otherwise applicable under national law. Rates applicable under national law, and reductions required by treaty, if any, appear in Table III F.

TABLE III F

	<i>Withholding Tax per National Law</i>	<i>Ceilings Fixed by Treaty</i>
Belgium	30%	(Exemptions in treaty do not apply to the 30% Taxe Mobilière)
France	24%	15%
Germany	25%	15%
Italy	0	(Ceiling fixed by treaty is higher than the tax actually assessed under local law)
Luxembourg	No treaty	15%
Netherlands	15%	0

The second additional tax implication arising from distribution of a part of the profits involves a change in the income tax load which would be assessed against the subsidiary itself in two of the six countries. In Belgium, the Taxe Professionnelle which is applicable only to *undistributed* profits would be substantially reduced, with the National Crisis Tax, applicable only to distributed profits, absorbing much of that reduction. In Germany, while the enterprise or trade tax would remain more or less constant, as indicated in PART I the subsidiary would enjoy a substantially reduced rate under the income tax with respect to that part of the profit distributed.

Table III G compares the income, property, and significant corporate enterprise taxes which would be levied by each member nation on the subsidiary in that year when 40% of its after-tax profits are distributed, and the amount of dividends which would be received by the American enterprise after paying foreign dividend taxes, if any.

At some point, the previously described subsidiary may have

TABLE III G

	<i>Income and Property Taxes Payable by the Subsidiary</i> 1	<i>Profit Retained for Expansion</i> 2	<i>Profit Distributed</i> 3	<i>Withholding Tax on dividends</i> ³³	<i>Net Dividends Received in U.S.A.</i>
	% of pre-tax profit	% of pre-tax profit	% of pre-tax profit	% of Clm. 3	% of pre-tax profit
Belgium ³⁰	24.9	45.06	30.04	30.	21.028
France	50.	30.	20.	15.	17.
Germany ³¹	64.89	21.066	14.044	15.	11.9374
Italy	44.67	33.20	22.13	0	22.13
Luxembourg ³²	51.67	28.998	19.332	15	16.4322
Netherlands	47.	31.8	21.2	0	21.2

³⁰ The formula used in note 20, *supra*, is more complicated here because of the need to take account of the National Crisis Tax (NCT). The formula would run as follows:

(1) $y = 0.4 (P - (NCT + TP))$, where y is the distributed profit, and NCT represents the National Crisis Tax of 20% thereon.

(2) $NCT = 0.2 y$

(3) $TP = d + p (P - y - TP - e)$

(3) $TP = \$73,850 + 0.4 (400,000 - y - TP - 200,000) = 109,893 - \frac{0.4}{1.4} y$

Formula (1) becomes:

(1) $y = 0.4 [400,000 - \{73,850 + 0.4(200,000 - y - TP) + 0.2 y\}] =$
 $= 0.4 [400,000 - (153,850 - 0.4 y - 0.4 TP + 0.2 y)] =$
 $= 0.4 [400,000 - (109,893 - \frac{0.4}{1.4} y + 0.2 y)] =$
 $= 0.4 (290,107 + \frac{0.12}{1.4} y)$

$y = \$120,163$ or 30.04% of total profit

³¹ The German formula used in note 22, *supra*, also becomes more complicated when account must be taken of distributed profits. The formula would run as follows:

(1) $y = 0.4 \{P - (G + V + K)\}$

As in note 22 $G = \$73,043$

$V = \$40,000$

24

(2) $K = \frac{15}{100} y + \frac{51}{100} (P - y - G) = \frac{15}{100} y + \frac{51}{100} (400,000 - 73,043) - \frac{51}{100} y$

$K = 166,748 - \frac{36}{100} y$

By substitution, formula (1) becomes:

(1) $y = 0.4 [400,000 - \{73,043 + 40,000 + (166,748 - \frac{36}{100} y)\}] =$

$y = 0.4 (286,957 - 166,748 + \frac{36}{100} y) = 0.4 (120,209 + \frac{36}{100} y)$

$y = \$56,172$ or 14.043% of total profit

³² The figures are pursuant to Luxembourg's national laws, as a bilateral tax treaty has not yet been concluded.

³³ See Table F for the withholding tax which would be assessed in the absence of the bilateral tax treaty with the United States.

discharged its indebtedness and abandoned further plans for expansion. Current distribution of all of that part of the \$400,000 in earnings which remain after payment of the subsidiary's own tax will serve, as in the immediately preceding case, to change the subsidiary's own tax liability in two of the six member nations, Belgium and Germany. And for the reasons cited in discussing the immediately preceding case, the net change in those two countries involves a further reduction, as is indicated in Table III H.

TABLE III H

	<i>Income and Property Taxes Pay- able by the Subsidiary</i> 1	<i>Profit Distributed</i> 2	<i>Withhold- ing Tax on Dividends</i> ³⁵ 3	<i>Net Divi- dends Received in U.S.A.</i> 4
	% of pre- tax profit	% of pre- tax profit	% of Clm. 2	% of pre- tax profit
Belgium	21.34	78.66	30% rate	55.062
France	50.	50.	15% rate	42.5
Germany	53.04	46.96	15% rate	39.916
Italy	44.67	55.33	0	55.33
Luxembourg ³⁴	51.67	48.33	15% rate	41.0805
Netherlands	47.	53.	0	53.

SUBSECTION 2. COMPARING PRIMARY INDIRECT BUSINESS TAXES OF MEMBER NATIONS

(a) *Turnover taxes.*—Each member nation's turnover taxes were discussed in the country-by-country survey in PART I, and certain general principles evolving from that discussion were applied in PART II in connection with an analysis of the tax effects of direct exports. The intention in Table III I is to chart a comparison of the *effective* rates which will normally be applied by each member nation at various stages of the manufacturing and distribution process. Effective, rather than stated, rates are used because in all countries except Belgium and Italy the turnover tax itself forms a part of the tax base (price) to which the stated

³⁴ See note 32, *supra*.

³⁵ See Table F for the withholding tax which would be assessed in the absence of a bilateral tax treaty with the United States.

rates are applied. Normal rates only are shown; legislation bearing on such taxes is so complex as to preclude a chart of all possibilities.

TABLE III I

	Manufacturer sells to :			<i>To Be Added to Wholesale- saler's price on Sale to Retailer</i>	<i>To Be Added to Retailer's Price on Sale to Consumer</i>
	<i>Whole- saler</i>	<i>Retailer</i>	<i>Consumer</i>	<i>Retailer</i>	<i>Consumer</i>
Belgium	5. %	5. %	0 %	5. %	0 %
France	25. % *	25. % *	25. % *	25. % *	2.83 %
Germany	4.17 %	4.17 %	4.17 %	1.01 %	4.17 %
Italy	3.30 %	3.30 %	3.30 %	3.30 %	0 %
Luxembourg	2.04 %	2.04 %	2.04 %	0.52 %	2.04 %
Netherlands	5.26 %	5.26 %	4.17 %	0.76 %	0 %

(* Since the French tax is actually a tax on added value, any such tax paid in earlier stages may be deducted by manufacturers or wholesalers except in the instance where the wholesaler pays only the local turnover tax of 2.83%. In fact, the manufacturer could even deduct turnover taxes previously paid on acquiring machinery, from turnover taxes due on the sale of his products. In case a manufacturer, in the capacity of a retailer, sells direct to consumers, instead of paying the 25% on the whole price, he may pay 25% on a hypothetical wholesale price plus 2.83% on the whole price.)

From Table III I, it appears that the amount of tax a consumer will ultimately bear depends in some instances on the character of the outlet from which his purchase is made as well as on the number of times the product has "turned over" prior to his purchase. In order to chart a comparison of the way the variable tax impact would affect the total price he would pay for a product from each outlet in each of the various countries, certain non-tax constants must be assumed. Table III J assumes that the pre-tax price charged by *each* outlet (manufacturer, wholesaler, and retailer) would include a flat \$20 net profit margin, the first such margin being included in the manufacturer's net pre-tax price of \$100 to wholesalers. It is further assumed that if a manufacturer or wholesaler sells directly to consumers, he will also enjoy the net profit margin which would have been normally received by the omitted outlets. Thus, a manufacturer selling directly to consumers would contemplate a pre-tax price of \$140.

TABLE III J

	Manufacturer to Consumer		
	<i>Through Wholesaler and Retailer</i>	<i>Through Retailer Only</i>	<i>Direct</i>
Belgium	151.25	146.00	140.00
France	174.80 ^{36 37}	174.80 ³⁶	172.75 ³⁶
Germany	151.48	151.05	145.84
Italy	147.37	143.96	144.62
Luxembourg	145.58	145.36	142.86
Netherlands	146.21	146.31	145.84

(b) *Registration and stamp duties.*—Each member nation imposes registration and/or stamp duties in connection with payment of capital into a subsidiary or capitalization of its reserves. The varying percentages charged on amounts originally paid in are reflected in Table III K.

TABLE III K

	<i>Registration Duty:</i>	<i>Stamp Duty:</i>	<i>Total:</i>
Belgium	1.6 %	.7 %	2.3 %
France	1.6 %	—	1.6 %
Germany	2.5 %	—	2.5 %
Italy	1%—2.5 % *	\$.02—\$1.90 (10—1,200 Lire)	
Luxembourg	.32%	.4 %	.72%
Netherlands	2.5 %	.75%	3.25%

* The 1% is applied to cash; 2.5% is applied to other capital assets brought into the business.

After formation of the subsidiary, subsequent increases in the subscribed or paid in capital may be subjected to somewhat different rates.

Introduction of capital into a permanent establishment, as dis-

³⁶ As previously noted, if the French manufacturer, on the purchase of raw materials, auxiliary goods, machines, etc., has paid a turnover tax, he may deduct the amount thereof from the tax payable by him on the sale of his product. This means that he is able to charge a selling price to the wholesaler (all other things being equal) which will be lower than that of his competitors in other countries. The actual consumer's price may, therefore, be lower than the amounts stated above.

³⁷ If the wholesaler pays the local turnover tax of 2.75% (effective rate, 2.83% in lieu of the value added tax (see PART I), the price will be \$173.88.

tinguished from a subsidiary, is also subjected to somewhat similar taxes in two of the six countries, Belgium and Germany. Illustratively, in Belgium the basic rate is .1% of the nominal paid in capital, with a minimum tax of \$360 (B. fr. 18,000) and a maximum of \$20,000 (B. fr. 1,000,000).

SECTION C. INTEGRATION OF FOREIGN TAXES INTO AMERICAN TAXATION OF BRANCHES AND FOREIGN SUBSIDIARIES SERVING ONE MEMBER NATION

(a) *Introduction.*—Earlier discussion in Section B of this PART indicated that direct taxes imposed by some Common Market countries differed by reference to the *form* in which the operation there was conducted. The difference between carrying on business there through a permanent establishment, as distinguished from a foreign subsidiary, can also give rise to substantial differences in the amount of income taxes imposed by the United States on any profits derived from abroad.

One will also discover that the American tax cost associated with activities carried on through a foreign subsidiary will vary, just as there was a variation in the tax cost imposed by some member nations, depending on whether profits are distributed or are plowed back into the operation.

In order to dramatize the practical significance of these various differences in American tax costs and in the total costs imposed domestically and abroad, discussion in this section will be confined, like that in preceding sections dealing solely with foreign tax costs, to operations which do not extend beyond the boundaries of a given member nation. Discussion of American and total tax costs in more expansive settings will be dovetailed between later sections which look only at the foreign tax costs of the same kind of expanding operation.

The analysis here will be divided into four parts. Discussion of the *basic* differences between American taxation of foreign branches and foreign subsidiaries, in terms of income, deductions, and credits, will be followed in Subsection 2 by an attempt to integrate the foreign and domestic tax costs associated with these two forms. Subsection 3 will consider the problem of allocating income and deduction items between American and foreign operations in the instance where the two conduct business with each other. Finally, Subsection 4 will focus on certain special or unusual problems which may be encountered in connection with the credit for foreign taxes.

The discussion with reference to all of these matters is based on the American tax pattern as it existed in September, 1960. Pending legislation which, if adopted, would dramatically alter the existing pattern, is discussed in Section B of PART VI, *infra*.

SUBSECTION I. BASIC DIFFERENCES BETWEEN AMERICAN TAXATION OF FOREIGN BRANCHES AND FOREIGN SUBSIDIARIES

(a) *Introductory note.*—The fact that United States taxes on profits earned abroad can differ markedly, depending on whether an American corporation chooses to conduct its Common Market business through a foreign branch or foreign subsidiary, is actually due to a quite limited number of *conceptual* differences in basic tax patterns, affecting however, all three parts of the ledger (gross income, deductions, and credits). From these few conceptual differences spring a host of practical tax differences.

The discussion below approaches the matter first by reference to differences in the amount of American *gross* income created by the two different forms. Analysis of the variation between those two settings in deductions and credits allowable for foreign income taxes then follows.

(b) *American "gross" income differences between branch and subsidiary operations.*—Differences on the gross income side are attributable to four basic tax concepts. The first is jurisdictional in nature; a *domestic* corporation's gross includes income earned by *every* branch or department from *all* sources, foreign as well as domestic.³⁸ Thus, jurisdictionally speaking, a foreign *branch's* gross, like that of a domestic branch, is includible as it is earned, whether or not remitted to the home office.

The second relevant basic tax concept relates only to operations conducted through a foreign *subsidiary* and, generally speaking, involves recognition of it as a taxable entity separate and apart from the domestic parent.³⁹ This notion of separateness, coupled with

³⁸ I.R.C., § 61. *Peck & Co. v. Lowe*, 247 U.S. 165, 38 S. Ct. 432 (1918).

³⁹ This basically stems from I.R.C., § 11. The concept of separateness here exceeds even that applied to a parent and subsidiary in a wholly domestic setting. Contrary to the case in the latter circumstance, a parent may not file a consolidated return with a foreign subsidiary. I.R.C., § 1504(b)(3). Nor is the 85% dividends received deduction allowed. I.R.C., § 243. The one circumstance where the corporate form of a foreign corporation is penetrated involves foreign personal holding companies the "undistributed foreign personal holding company income" of which may be taxed to American shareholders even though not distributed.

the third basic concept—another jurisdictional principle to the effect that a foreign corporation *itself* is taxable by the United States only on income having its source *within* the States,⁴⁰ serves in our situation to immunize the foreign subsidiary itself from American taxation. However, when the notion that the two corporations are separate is coupled with the *first* mentioned jurisdictional principle, the effect will be to swell the domestic *parent's* own gross by the amount of any dividend received from the subsidiary.

The fourth relevant basic concept involves the matter of *accounting methods*, a much more detailed discussion of which appears later in Section B of PART IV. While it is theoretically true, *jurisdictionally* speaking, that the *gross* income of a foreign branch is includible in American gross income, for *accounting* purposes, i.e., in terms of an accounting method, only the branch's separate pre-tax *net* profits—computed according to American standards—need actually be brought across the ocean in the more usual circumstance.⁴¹ Equally important, but again only as a matter of accounting, computation of those separate net profits may include reflection of any shift in the net worth of the branch's current assets by reason of changes in exchange rates, though nothing is actually remitted to the home office.⁴² The current asset accounts of a subsidiary, on the other hand, are not normally penetrated in this fashion, for it is a separate entity.⁴³

These diverse conceptual patterns can have more than one *practical* effect on American "*gross*" income.

First, the American *gross* from a branch operation will normally exceed the amount which would be included if the foreign operation is conducted through a subsidiary. Even if it is decided that a subsidiary will not retain any of its net profits for expansion, the dividend which will be included in the parent's gross will relate only to that part of the subsidiary's profit which remained *after* payment of any foreign income taxes. For example, of a subsidiary's pre-tax profit of \$400,000 in the Netherlands, only \$212,000 would be available for dividends, the balance being absorbed by that country's 47% income tax. From a branch operation located there, how-

⁴⁰ I.R.C., § 882(b).

⁴¹ O.D. 550, C.B. 2, 61 (1920). Also, American Pad & Textile Co., 16 T.C. 1304 (1951), discussed more fully in Section B, PART IV, *infra*.

⁴² Viotor & Achelis v. Salt's Textile Mfg. Co., (D.C. Conn. 1928) 26 F.(2d) 249, discussed more fully in Section B, PART IV, *infra*.

⁴³ G.C.M. 4954, C.B. VII-2, 293 (1928), cited with approval in American Pad & Textile Co., 16 T.C. 1304 (1951). Cf. the agreement between the government and a taxpayer, reflected in Anderson, Clayton & Co., (Ct. Cl. 1958) 168 F. Supp. 542.

ever, the American parent's *gross* would be enhanced by the branch's entire pre-tax profit of \$400,000.

The ultimate American tax differential in this instance is not as great, however, as the difference between the two amounts of American *gross* income (\$212,000 and \$400,000) might suggest. Discussion in the next subtopic discloses in a branch setting that the domestic corporation may treat the foreign income tax of \$188,000 as a deduction from gross income⁴⁴ or as a credit against the American tax itself.⁴⁵ But it is also indicated there that some difference in American tax costs will remain even if, under the subsidiary arrangement, all of its after-tax profits are remitted to the parent. The exclusion from American gross income of that part of the subsidiary's profit devoted to the foreign income tax is one of the contributing factors, for that exclusion is economically equivalent to a deduction for the foreign tax. Nevertheless, *in addition* to that exclusion, the parent will enjoy a *credit* for a part, and in this instance a substantial part, of the subsidiary's foreign income tax.⁴⁶ In the branch setting, it will be recalled, a choice between the two methods of accommodating foreign taxes (deduction and credit) had to be made.⁴⁷

Going back, however, to the *gross* income side of the ledger, the determination of the *amount* to be included by the American company depends, in the case of both forms of operation, on American tax concepts, not on those of a foreign country. When applied, however, this notion gives rise to certain peculiar twists, and when commingled with the circumstances where foreign tax law plays a slightly different role, it can give rise to a second kind of difference in the amount of American gross income, one wholly apart from the difference attributable to reasons explained in the preceding paragraphs.

The basic idea, that the amount to be included in American gross income is determined by *federal* tax concepts, is easy to see in the setting of a branch. Theoretically, i.e., at least for jurisdictional purposes, all of its transactions are reached at the *gross* income level by § 61 of the Code.⁴⁸ Again speaking jurisdictionally, since both domestic and foreign operations are housed in one corporate

⁴⁴ I.R.C., § 164(a) and (b)(6).

⁴⁵ I.R.C., § 901.

⁴⁶ I.R.C., § 902.

⁴⁷ See note 44, *supra*.

⁴⁸ Since *Doyle v. Mitchell Bros. Co.*, 247 U.S. 179, 38 S. Ct. 467 (1918), it has been recognized that American tax statutes have not *formally* taken *gross receipts* as the point of departure.

entity domiciled in the States, after integrating the foreign transactions with domestic ones at the gross income level, deduction for expenses on both sides of the water, but only as permitted by American law, would be taken in arriving at a consolidated American version of "taxable income." The fact, for *accounting* purposes, that the *net* profits of a foreign branch are actually computed in the usual case separate from those attributable to domestic operations means only that integration in fact relates just to the net result, not that the latter is computed by reference to something other than the American version of "taxable income."⁴⁹

Applicability of this same choice-of-law principle to operations housed in a foreign subsidiary is less obvious only because there is a difference in the jurisdictional reach of the United States over profits earned by the two different forms of operation. Whenever a foreign subsidiary does distribute property to its American parent, thus bringing the item within the taxing jurisdiction of the United States, the extent to which that item will be deemed a "dividend" and, therefore, includible in the parent's gross income, depends—according to § 316 of the Code—upon the distributing foreign corporation's "earnings and profits" structure calculated by reference to federal rules.⁵⁰ Illustratively, if a foreign corporation distributes an amount *greater* than its earnings and profits as computed under foreign tax law, the *entire* amount of the distribution may still be treated as a taxable dividend, fully includible in American gross income, *if* the total amount could be accommodated under the American version of that foreign corporation's "earnings and profits."⁵¹ But one should not suppose from this that the shape of foreign tax law will never affect the amount of American gross income. Suppose that the foreign country imposes a 52% corporate tax, but that it allows less by way of deductions than would be permitted under American law. Since the foreign corporation will normally not distribute more than its *after-tax* profit, foreign tax law has had the indirect effect of reducing American *gross* income, for the latter will not include more than the amount of dividend actually paid. In a branch setting, however, the differential just noted would not affect American *gross* income, though, as

⁴⁹ The fact that a foreign branch's operations will usually be conducted in terms of a foreign currency does create problems in computing taxable income which are peculiar to foreign operations. But these too are resolved according to American tax concepts. See Part IV, *infra*.

⁵⁰ *Untermeyer v. Comm'r*, (2d Cir. 1932) 59 F. (2d) 1004. For the general definition of "earnings and profits," see I.T. Regs., § 1.1312-6.

⁵¹ *Ibid*

we shall later see, the credit allowed for foreign taxes may be affected in both cases.

The factual situation at the other extreme, i.e., where *all* profits of the foreign operation are to be retained there to discharge indebtedness or facilitate expansion, highlights the difference in America's taxing jurisdiction and dramatizes the third and most striking practical difference in the amounts of American gross income which would be derived from the two different methods of operation. While the parent would still have \$400,000 in *gross* income from a branch—the remission of profits being a neutral consideration, the absence of a dividend in the setting of a subsidiary would immunize its foreign profits from the American tax. Something more than mere deferral for a short period may be involved, for dedication of those profits to machinery, bricks, and mortar may well mean that those profits are isolated from the reach of the American treasury for the entire period during which business will be conducted through that subsidiary, though increased profits generated by the expansion may lead to larger dividends in the interim.

The opportunity through a foreign subsidiary arrangement to isolate foreign earnings from the domestic parent's gross income and, therefore, from American tax is most advantageous in a country with a tax pattern like that of Belgium. The *total* Belgian and American income taxes suffered by the profits of a permanent establishment in Belgium will equal the effective rate of that country which imposes the greater tax, here the 52% figure imposed by the United States which will then give a credit for the smaller Belgian tax. A foreign subsidiary which derived its entire income from Belgian sources could, on the other hand, retain more than 70% of its earnings for further development, suffering only Belgian income taxes of less than 30% during the retention period. The retained profit would also be sheltered from the American penalty tax on unreasonable accumulations;⁵² since the foreign profit has not yet taken on the complexion of American gross income, it could not be "accumulated taxable income" to which this U.S. surcharge relates. And this would be so even if the profit were deposited in an American bank, provided the foreign subsidiary made the deposit without declaring a dividend to the parent. Nor, according to the discussion in PART I, do any of the Common Market countries have a counterpart penalty tax on unreasonable accumu-

⁵² I.R.C., § 531 et seq.

lations. Section C of that PART did indicate, however, that Germany's *regular* corporate income tax imposed a much higher rate on a subsidiary's retained profits than on its distributed profits, the rate on the former usually being higher than that imposed on a branch operation.

Any advantage enjoyed by a subsidiary arrangement over a permanent establishment *solely* because of the opportunity of the former to store up profits free of the American tax necessarily becomes less significant as the foreign rate on *undistributed* profits begins to approximate the American rate. Illustratively, if one considers only *stated* comparative rates, the flat 47% Netherlands rate on the retained profits of a subsidiary domiciled there is not markedly different from the 52% American rate which, being the greater of the two, would create a higher, though only slightly higher, tax cost for a permanent establishment. The flat 50% French rate on retained profits is an even more persuasive illustration of the same principle.

Going back to the first factual situation, i.e., where all profits were currently remitted, it will be recalled that the two forms would create different amounts of American *gross* income only because that portion of a subsidiary's profits used by it to pay foreign income taxes would not come within the jurisdictional reach of the United States, it being otherwise in the case of a branch operation. From this principle emerges a fourth practical difference in the amounts of American gross income which would be derived from the two forms of operation. This fourth difference is attributable to the fact that the tax pattern used by a Common Market country with reference to permanent establishments may differ from that associated with subsidiary arrangements. In both cases, the Netherlands imposes only one 47% tax. Belgium, however, again illustrates the effect of a variable tax pattern. A Belgian subsidiary distributing all of its after-tax profits would suffer a 20% National Crisis Tax on the gross dividend. Whereas the foreign subsidiary itself would suffer the more demanding 30% effective rate of the *Taxe Professionnelle* only with respect to that part of its profits used to pay the lower 20% National Crisis Tax, the higher rate of the *Taxe Professionnelle* would apply to the *entire* income of a permanent establishment. Even in the absence of this variation, there would, of course, be a difference in the amount of American gross income created by the two different forms; as previously noted, that portion of a subsidiary's

profits used to pay its own foreign income taxes is not includible by the parent, the opposite being true in the case of a branch. This constant difference is further affected in degree, however, by the variation in the tax imposed directly on the two forms by the foreign country. Even so, one should not jump merrily to the conclusion that the *total* Belgian income tax associated with a subsidiary arrangement is actually less than that associated with a branch in the instance where all profits are distributed. In fact, as we saw in Section B *supra*, the contrary is true. Again assuming a foreign pre-tax profit of \$400,000, in addition to the \$85,360 tax borne by the foreign subsidiary itself, Belgium would also withhold 30% of the \$314,640 dividend as a tax against the recipient, this being another \$94,392. While the latter tax will not reduce American *gross* income, it will bring the total Belgian tax on the subsidiary arrangement to \$179,752, compared with \$120,000 assessed against the permanent establishment. But again, it is important to distinguish between the effect of the foreign tax on American *gross* income and its quite different effect on the American tax itself. Indeed, as we shall later see, because of the peculiar way in which the American credit for foreign taxes works in this type of case, the total *two-country* tax associated with the subsidiary arrangement will be less than that borne by the branch operation.

Loss situations furnish a fifth circumstance in which the amount of American gross income will be affected by the organizational arrangement. Operating losses suffered by a foreign branch will serve immediately to offset income earned by the parent in the United States. Integration of this type is not permitted, however, where the loss is suffered by a foreign subsidiary. Its affairs may not even be integrated with that of the parent on a consolidated return.⁵³ Outside of the Netherlands, a subsidiary's operating losses can only be used to offset its own income in future years through resort to foreign *carry-over* provisions. As indicated in PART I, all Common Market nations permit such a carry-over. The usual limitation is 5 years, though Luxembourg confines the privilege to 2 years, and the Netherlands extends it to 6 years and to an indefinite period in the case of new businesses. The Netherlands is also the only member nation which permits the loss to be carried back, a refund being available through an offset

⁵³ I.R.C., § 1504(b) (3).

of income of an earlier year. This privilege is limited, however, to the year immediately preceding the loss year.

Also with respect to loss operations abroad, differences in the effect of the two forms may arise in the event a foreign facility which started as a loss operation continues downhill to a point where the American company decides to rid itself of the undertaking. The character which the Internal Revenue Code would assign to losses arising from disposition of a foreign permanent establishment's assets would depend upon the exact nature of each separate asset.⁵⁴ Illustratively, inventory losses would offset ordinary income realized by the American company from its United States operations. Losses from the sale of depreciable equipment or buildings might also be treated in this favorable fashion; under § 1231, it would seem that these should be packaged with like transactions growing out of American operations, and if the net effect of all such transactions is a loss, the foreign dispositions are not treated as sales or exchanges of capital assets.⁵⁵

On the other hand, loss arising from an American company's sale of stock in a foreign subsidiary would normally be treated as a capital loss, deductible only against the parent's capital gains, if any.⁵⁶ The one prime exception to this involves the case where the stock of an almost wholly owned foreign subsidiary becomes *completely* worthless, in which case the American domiciled parent corporation will usually enjoy an *ordinary* loss deduction in the year the stock became worthless.⁵⁷ Partial worthlessness, i.e., a mere reduction in value below the parent company's adjusted basis, cannot, however, be so treated even though realized by a sale of the stock. Absent complete worthlessness of the parent's stock, the same unfavorable capital loss treatment would follow if the foreign subsidiary first sold its assets and then, on liquidation, distributed proceeds to the parent in an amount less than the latter's adjusted basis.⁵⁸ Of course, as is sometimes attempted in wholly American settings, an effort might be made to liquidate the subsidiary prior to disposition of its assets, the thought being that those assets would then be sold by the American parent while

⁵⁴ This principle goes back to *Williams v. McGowan*, (2d Cir. 1945) 152 F.(2d) 570.

⁵⁵ While the Service has generally recognized that the profits of a branch are to be computed separately (see note 41 *supra*), it is doubtful that it intended, or is free, to disregard the mandate of § 1231 in determining the character of income.

⁵⁶ I.R.C., §§ 1221 and 1211(a).

⁵⁷ I.R.C., § 165(g).

⁵⁸ I.R.C., §§ 331(a)(1) and 1221.

the foreign facility occupies its new status as a permanent establishment. The aim of the parent corporation, to shift what would have been a capital loss on sale of stock to the more favorable treatment which might be accorded a loss on sale of inventory and § 1231-property, will not be realized, however, if the added tax benefit constituted one of the principal purposes behind the subsidiary's earlier liquidation.⁵⁹

If current operating losses are incurred by facilities in the United States rather than those in a foreign country, a foreign branch's profit, if any, will serve immediately to reduce the loss, for it must be integrated into the parent's gross income whether or not remitted to this country. But a foreign subsidiary's profit will not be integrated so as to offset a part of the operational loss in the United States unless it is paid out as a dividend. Using the previous illustration of a \$400,000 pre-tax profit in the Netherlands as an example, a dividend of the subsidiary's after-tax profit of \$212,000 would neutralize that much loss in United States operations. While a branch's entire profit of \$400,000 would be integrated with the American loss, election to *deduct* the foreign income tax of \$188,000 would lead to a result similar to that which followed a subsidiary's distribution of its after-tax profit of \$212,000. In both cases, losses attributable to the American operation would be offset by a *net* of \$212,000.

(c) *Origin of the "deduction" for foreign taxes, and the difference in its applicability to subsidiary and permanent-establishment operations.*—The first income tax act passed pursuant to the Sixteenth Amendment authorized corporations, but not individuals, to *deduct* from gross income taxes "imposed by the government of any foreign country."⁶⁰

While something more than foreign *income* taxes was accommodated by this provision, income itself was not thereby confined, even in terms of ultimate effect, to taxability by but one country. The effect on a corporation which conducted its affairs abroad through a permanent establishment was to shift the economic burden of foreign income taxes to the federal treasury *only* to

⁵⁹ I.R.C., § 367.

⁶⁰ Rev. Act of 1913, Section II, G(b) (Fourth). Like provision for individuals was made in Rev. Act of 1916, § 5(a) (Third). The present counterpart of the early provision makes it clear that the deduction would also be available to a corporation in the case of taxes imposed by foreign states, provinces, or local units of government except where assessed against local benefits of a kind tending to increase the value of the property assessed. I.R.C., § 164(a) and (b) (5).

the extent of the corporation's effective domestic rate. Illustratively, the highest rate imposed on corporations prior to World War I was 2%.⁶¹ The over-all ultimate *effect* then was that a domestic corporation, operating a foreign permanent establishment, actually had to bear all of the American tax load plus 98% of the direct taxes imposed by the foreign country. While this was not very critical at a time when corporate rates were so low, in the following sub-topic we shall see that Congress was to view the adequacy of the deduction in a different light as the world moved into the higher tax rates required by World War I.

Where an American corporation chose to operate abroad through a foreign subsidiary, it could, of course, deduct any withholding tax which the foreign country might impose *directly* on the parent with reference to dividends received from the subsidiary.⁶² But, unlike domestic corporations which housed foreign operations in a permanent establishment, the American parent could not deduct foreign taxes imposed directly on its subsidiary. Like other deductions, this particular deduction then, as now, was generally available only to the person or entity upon whom the expense was *directly* imposed.⁶³ As a practical matter, however, it must be remembered that the subsidiary would normally confine distributions to those profits which remained *after* payment of its own foreign taxes. In effect, and contrary to the circumstance in the setting of a permanent establishment, that portion of the subsidiary's profits absorbed by foreign taxes was actually *excluded* from American *gross* income. And this *exclusion*, available only in the case of operations conducted through a foreign subsidiary, was just as beneficial as the *deduction* to which the permanent-establishment arrangement was then confined. Thus, in terms of over-all effect, the deduction provision did not actually discriminate against foreign subsidiary arrangements. In fact, insofar as one looked only at America's total response to foreign taxes, parity between the two different organizational arrangements had been achieved as this country approached World War I.

(d) *Parity retained: Denial of a deduction for inter-corporate dividends received from a foreign corporation.*—Ameri-

⁶¹ Rev. Act of 1916, § 10.

⁶² It is not always easy to determine whether a dividend tax is imposed on the recipient or on the distributor. Illustrative of the difficulty, see Rev. Rul. 56-289, C.B. 1956-1, 321.

⁶³ *Biddle v. Comm'r*, 302 U.S. 573 58 S. Ct. 379 (1938); *Ritter Lumber Co.*, 30 B.T.A. 231 (1934); Rev. Rul. 56-289, C.B. 1956-1, 321; and I.T. 2235, C.B. IV-2, 82 (1925).

ca's entry into World War I and the concurrent increase in rates was accompanied by elimination of the double domestic tax which fell on those corporate profits earned by *domestic* subsidiaries.⁶⁴ Until 1917, profits on which a domestic subsidiary had paid a tax were again taxed when received as a dividend by the domestic parent. The provision adopted in that year, freeing intercorporate dividends from the second tax, is now characterized as the 85% dividends received deduction, meaning that 15% of such dividends will not now enjoy immunity at the dividend stage.⁶⁵ However, care was taken then,⁶⁶ as now,⁶⁷ to deny this benefit to dividends received from a foreign subsidiary, the reason being that the latter, unlike a domestic subsidiary, was not itself taxed by the United States with reference to its foreign profits. Looking at the matter only in terms of domestic taxation, the double tax difficulty did not exist in such case.

In the instance where a foreign subsidiary distributed all of its after-tax profits as a dividend, the foregoing statutory limitation served to keep the American tax on a par with that which would fall on a permanent-establishment arrangement. The deduction which the latter enjoyed with respect to foreign taxes was matched by an exclusion of that part of the subsidiary's profits devoted to foreign taxes.

(e) *Parity eliminated: Origin and differences between the "direct" and "deemed-paid" credits, and their basic relationship to the deduction for foreign taxes.*—Because of increased costs associated with the conduct of World War I, to a new regular corporate rate of 12% in 1918,⁶⁸ the government tacked on an increase in the tax on excess profits, the first bracket of which was now subjected to a rate of 30%.⁶⁹

On the one hand, because of the deduction allowed for foreign taxes, the higher rate schedule meant that the United States Treasury would be assuming an increased share of a corporation's own foreign tax load. But this was small comfort when account was taken of the fact that foreign countries were also tacking on much higher war profits taxes, a substantial part of which—in

⁶⁴ Rev. Act of 1917, § 4.

⁶⁵ I.R.C., § 243.

⁶⁶ Rev. Act of 1917, § 4 limited the immunity to dividends received from a corporation "which is taxable upon its net income as provided in this title. . . ."

⁶⁷ I.R.C., § 243 limits the deduction to dividends received from a "domestic" corporation.

⁶⁸ Rev. Act of 1918, § 230(a).

⁶⁹ *Ibid.*, § 301(a).

spite of the deduction—had to be borne by the American enterprise. It was in response to this circumstance that Congress, in 1918, authorized corporations, as well as individuals, to take a *credit* against their American tax liability for foreign “*income, war profits, and excess profits taxes*” paid or accrued during the taxable year.⁷⁰

While the new provision did not deprive taxpayers of the right to deduct from gross income any foreign tax which, because of its type, was ineligible for the credit, benefits with reference to qualifying types could not be doubled by also taking the previously permitted deduction.⁷¹ In fact, the present counterpart of the earliest prohibition prevents a taxpayer from availing himself of the deduction with reference to qualifying taxes if he “chooses to take *to any extent* the benefits” of the credit.⁷² While more will be said of this matter later, in practice the limitation means that taxpayers will deduct qualifying taxes, instead of taking a credit, only where they are interested in increasing the amount of a current net operating loss which can be carried back for immediate refund purposes.

Standing alone, the *basic* provision regarding the credit did not accommodate all of the foreign income taxes which might be imposed in connection with a foreign subsidiary arrangement. Contrary to the case where the foreign business was carried on through a permanent establishment, foreign income taxes imposed *directly* against a subsidiary itself were not taxes, *qua* taxes, against the American parent. Accordingly, the latter, by reference only to the *basic* provision, could have taken a credit *only* for such income taxes, if any, which the foreign government might have assessed, and withheld, against the parent in connection with dividend payments. In 1918, however, the Senate Finance Committee was also concerned with a second and quite different problem, the tentative resolution of which ultimately had an effect on the right of a parent to enjoy some credit for a foreign subsidiary's own income taxes.

That committee felt that affiliated corporations, even those engaged only in domestic activities, were not properly allocating the burdens and benefits of inter-company transactions. Moreover, it was thought that the then existing law “put an almost irresistible

⁷⁰ Rev. Act of 1918, § 238. See also Section C, PART V, *infra* re individuals. H. Rep. No. 767, 65th Cong., 2d Sess. 11 (1918). Italics added.

⁷¹ Rev. Act of 1918, § 234(a)(3).

⁷² I.R.C., § 164(b)(6). Italics added.

premium on a segregation or a separate incorporation of activities which would normally be carried as branches of one concern.”⁷³ Over and above these considerations, it was also felt that “the principle of taxing as a business unit what in reality is a business unit is sound and equitable and convenient to the taxpayer and to the Government.”⁷⁴ The proposed solution: to require affiliated corporations to file a consolidated return under regulations prescribed by the Treasury.⁷⁵ Since this would have the effect of converting a subsidiary into a branch for American tax purposes, as applied to a domestic parent and a *foreign* subsidiary it was only right that the same Committee went on to propose allowance of a *full* credit against the consolidated tax for any qualifying foreign taxes of the subsidiary⁷⁶ as well as of the parent. Because of this credit, though American gross income would have included the *pre-tax* profit of the foreign subsidiary, a further deduction against consolidated gross income for qualifying foreign taxes was to be prohibited.⁷⁷

For unstated reasons, a conference committee eliminated the consolidated return requirement as it related to *foreign* affiliates,⁷⁸ thus freeing that part of a foreign subsidiary's income sourced abroad from the reach of the Treasury except to the extent such was distributed as a dividend to the parent. But with some revision, the committee retained and the Congress adopted the provision which authorized the American parent, upon receipt of a dividend, to take some credit for qualifying foreign taxes paid by the foreign subsidiary.⁷⁹ This result was accomplished by saying that the parent would be “deemed” to have paid such taxes.

While that early statute did go on expressly to deny a *deduction* for those same taxes,⁸⁰ it completely ignored the fact that elimination of the consolidated return requirement, of which the pass-through arrangement as to foreign taxes was originally only a part, had the effect of enabling the parties to *exclude* from American gross income that part of the subsidiary's profits used to pay the foreign taxes. Thus, if the foreign subsidiary distributed its entire

⁷³ S. Rep. No. 617, 65th Cong., 3d Sess. 8-9 (1918).

⁷⁴ *Id.* at 9.

⁷⁵ See the Senate's version of H.R. 12863, 65th Cong., 3d Sess. (1918), § 240, later adopted in Rev. Act of 1918, § 240.

⁷⁶ *Ibid.*, Senate's bill, § 240(c).

⁷⁷ *Id.*, § 234(a) (3).

⁷⁸ H. Rep. No. 1037, 65th Cong., 3d Sess. (1919), C.B. 1939-1 (Part 2) 130 at 143.

⁷⁹ *Ibid.* Revenue Act of 1918, § 240(c).

⁸⁰ Rev. Act of 1918, § 234(a) (3).

after-tax profit, *exclusion* from American gross income of that part of its profits used to pay its own taxes was the economic equivalent of a *deduction* for those taxes. Moreover, in this factual circumstance, the added benefit of the "deemed paid" credit—under the provision as originally enacted—apparently related to *all* of the subsidiary's qualifying taxes, subject to one limitation not relevant to the present discussion.⁸¹ And this was so though that part of its profits used to pay the foreign tax was not itself being taxed by the United States. Three years later, however, the language of the earlier credit provision was changed; under the 1921 Act, *as today*, the parent, upon receipt of a dividend, was deemed to have paid only that proportion of the qualifying taxes as were paid by the subsidiary "upon or with respect to the *accumulated profits* of such foreign corporation from which such dividends were paid, which the amount of such dividends bears to the amount of such accumulated profits. . . ." ⁸²

While a very substantial controversy arose thereafter as to the reason for this change, and over the question of whether a meaningful change had in fact taken place, the Supreme Court finally decided that the law had taken on a new complexion.⁸³ Illustratively, suppose that out of its pre-tax profits of \$100,000 for the current year, a foreign subsidiary paid \$26,000 in income taxes to a Common Market country, remitting the balance of \$74,000 to an American parent as a dividend. The *American Chicle Co.* case⁸⁴ decided that the pre-dividend "accumulated profits" in this situation would amount only to \$74,000 with the consequence that the fraction mentioned in the statute's proportional formula, quoted *supra*, was $\frac{\$74,000}{\$74,000}$ or $\frac{I}{I}$. By the same token, the ultimate statutory multiplicand to which this fraction was to be applied ("taxes paid by such foreign corporation. . . . upon or with respect to the *accumulated profits* from which such dividends were paid") ⁸⁵ amounted to $\$26,000 \times \frac{\$74,000}{\$100,000}$ or \$19,240.

⁸¹ *Id.*, § 240(c). See the discussion in *American Chicle Co. v. U.S.*, 316 U.S. 450, 62 S. Ct. 1144 (1942).

⁸² Rev. Act of 1921, § 238(e), now I.R.C., § 902(a).

⁸³ One of the difficulties, *e.g.*, was the fact that an explanation on the Senate floor was opposite to the specific result which the Supreme Court reached. See statement of Senator Smoot, 61 Cong. Rec. 7184 (1921).

⁸⁴ This example is similar to one used in the lower court's decision, *American Chicle Co. v. U.S.*, (Ct. Cl. 1941) 41 F. Supp. 537, but the result was affirmed in 316 U.S. 450, 62 S. Ct. 1144 (1942).

⁸⁵ Italics added.

In other words, \$6,760 or 26% of the subsidiary's own income tax was paid to the foreign country with respect to something other than its "accumulated profits" of \$74,000. Specifically, the \$6,760 was linked to that part of the subsidiary's pre-tax profits which was absorbed by the foreign tax itself (\$26,000). Two countries were not, of course, taxing that part; of the \$100,000 taxed by the foreign country, only \$74,000 (the dividend) remained to be taxed by the United States.

Thus, out of the chronology previously related emerged two basic ideas which prevail to this day:

(1) Time-wise, whereas the permanent-establishment arrangement enables an American corporation to take a *direct* credit for a branch's qualifying foreign taxes in the year the foreign tax is paid or accrued and without regard to the matter of remittances to the States, the availability of the quite different "deemed-paid" credit to an American parent of a foreign subsidiary was linked to the former's receipt of a dividend; and

(2) Using the earlier example again as an illustration, whereas a permanent-establishment arrangement would have led to an American gross income of \$100,000 with the American corporation having a choice between a credit or deduction in the amount of the *full* foreign tax of \$26,000, the subsidiary arrangement gave rise to an *exclusion* of that same \$26,000, leaving American gross income (a dividend) of \$74,000—the American tax on which could also be *credited* with \$19,240 or 74% of the foreign tax which, in its entirety, had been the subject of the previously mentioned exclusion.

While it was assumed in the latter illustration that the foreign tax was the same under the two arrangements (\$26,000), the net effect of the foregoing developments on the American tax created a difference in the two settings, and because of this the *combined* foreign and domestic income taxes suffered by the two arrangements differed. Assuming a flat 52% American rate, the *net* American tax in the setting of a permanent-establishment arrangement would also be \$26,000 ($\$100,000 \times 52\%$ less the direct credit for foreign taxes of \$26,000), and this, coupled with the foreign tax of \$26,000, resulted in combined foreign and domestic taxes of \$52,000. Where a permanent establishment is used, the *combined* income taxes will always be 52% in that instance where the foreign tax is *less* than the American tax.

A different result is reached, however, in the case of a foreign subsidiary which has declared a dividend of all of its after-tax profits. Pursuing the original illustration further, the net American tax would be only \$19,240 ($\$74,000 \text{ dividend} \times 52\% = \$38,480$ less the deemed-paid credit of \$19,240) as against \$26,000 in the permanent-establishment setting. The *combined* taxes of the two countries with reference to the subsidiary's profits and subsequent dividend would then be only \$45,240 or 87% of that suffered if a permanent establishment were used.

It will be noted that the effective foreign rate in our illustration (26%) was exactly half the American rate (52%). Assuming a subsidiary distributes all of its after-tax profits, this particular rate relationship represents that point where the subsidiary arrangement will have the greatest tax advantage over the permanent-establishment setting. The tax advantage of the former arrangement decreases in the assumed situation (full dividend) as that rate relationship is changed, up or down.

If the foreign country does not resort to income taxation at all, the effective rate being 0, the subsidiary type of organization will provide no advantage whatever over a branch arrangement—assuming again that the subsidiary distributes all of its profits as a dividend ($\$100,000 \text{ dividend} \times 52\% = \$52,000$ less 0 deemed-paid credit). Indeed, pursuant to that same assumption of full dividends and laying aside for the moment any comparison to permanent establishments, the *combined* income taxes of the two countries on a subsidiary arrangement will be *less* if the foreign country imposes some income tax than if it imposes none at all, provided only that its tax is not as great as the tentative (pre-credit) American tax.

This startling result stems from the fact that the foreign income tax enjoys the equivalent of a deduction (exclusion) as well as some credit.

Returning to the comparison with permanent establishments, and to the fact that the subsidiary's advantage during a period of full dividends will also be reduced as the foreign country's effective rate moves from the mid-point (26%) to the other extreme corresponding to the American rate of 52%, it will be noted that a foreign tax of 52% will *alone* equal the *combined* tax in the setting of a permanent establishment, \$52,000. The American tax on a subsidiary's dividend will also be completely neutralized in such case ($\$48,000 \text{ dividend} \times 52\% = \$24,960$ less a deemed-paid credit of

\$24,960 computed as follows: $\$52,000 \times \frac{\$48,000}{\$100,000} = \$24,960$).

The ultimate advantage which the foreign subsidiary type of arrangement may enjoy over a branch—the exact degree being dependent upon the foreign rate and attributable to the combined exclusion *and* credit allowed for that foreign tax, would be lost, of course, if dividends received by an American parent from such a subsidiary were “grossed up” by the amount of the foreign income tax, *full* credit for that tax then being allowed as in the case of a branch. Present congressional interest in such a “gross up” requirement is dealt with in Section B of PART VI, *infra*, in the setting of other projections regarding possible future changes in both foreign and American tax patterns.

While it appears under the present pattern that the advantage of the subsidiary in a period of *full* dividends gradually decreases as the effective rate of the foreign tax moves up or down from a mid-point fixed at exactly half of the American rate, equally important are two other correlative principles.

The first of these is most dramatically illustrated in that circumstance where a subsidiary retains all of its after-tax profits in order to discharge long term liabilities or facilitate expansion. The deemed-paid credit, since linked to dividends, will not presently be available; but neither will there be any American gross income. The total *current* tax liability will be determined solely by reference to the effective foreign rate.

In terms of current tax liability, the subsidiary's advantage over a permanent establishment increases in the last assumed situation (no dividends) as the foreign rate moves downward from 52%. In the setting of our original illustration of a 26% foreign rate, the current combined tax load on the subsidiary arrangement would be just half of that amount suffered by the permanent-establishment arrangement.

The difference in the amount of advantage enjoyed by the subsidiary arrangement in the *absence* of dividends, and that enjoyed by it even where *all* after-tax profits are *distributed*, is whittled down if the subsidiary distributes even a part of its after-tax profits, retaining the balance. Illustratively, if it distributes half of its after-tax profits of \$74,000, the numerator of the previously quoted statutory fraction governing the deemed-paid credit becomes \$37,000, the fraction then being $\frac{\$37,000 \text{ dividend}}{\$74,000 \text{ accumulated profits}}$ or $\frac{1}{2}$. Multiplied by the ultimate statutory multiplicand (\$26,000

$\times \frac{\$74,000}{\$100,000}$ or \$19,240) which remains unchanged, the deemed-paid credit allowed with reference to the \$37,000 dividend turns out to be \$9,620 ($\$19,240 \times \frac{1}{2}$) which is set off against the tentative American tax liability of \$19,240 ($\$37,000 \times 52\%$), producing a net American tax of \$9,620 ($\$19,240$ tentative tax less deemed-paid credit of \$9,620). This, together with the foreign tax of \$26,000, results in a combined current tax for the subsidiary arrangement of \$35,620 compared with \$52,000 which would be assessed in the setting of a permanent establishment.

The second important correlative principle, discussed more fully in the next subtopic, has the effect, *inter alia*, of foreclosing the chance that the credit for foreign taxes might neutralize American tax liability on income which the parent corporation derives from sources *within* the United States. Thus the combined taxes can be greater than 52% if the effective foreign rate exceeds the effective American rate.

(f) *The per-country limitation.*—It was in 1921 that Congress first acted to prevent credits for foreign taxes from offsetting any part of one's tax attributable to income earned *within* the States.⁸⁶ While that provision, known as the "over-all" limitation, was later discarded and then revived in 1960, a complementary and in some respects more confining ceiling, first enacted in 1932⁸⁷ and characterized as the per-country limitation, has remained intact since its inception.⁸⁸ Its general thrust is to the effect that the total credit claimed for qualifying taxes paid or accrued to a particular country should not exceed the amount of tax which the United States would impose, before credits, on income having its source in that foreign country.

That part of the provision's limiting fraction which is most likely to be applied to the taxpayer's pre-credit American tax, the aim being to fix a ceiling on the *total* direct and deemed-paid credits otherwise available for taxes paid or accrued to a particular country, reads as follows:

$$\frac{\text{"Taxable income from sources within such country"}^{89}}{\text{"Entire taxable income for the same taxable year"}}$$

⁸⁶ Rev. Act of 1921, § 238(a).

⁸⁷ Rev. Act of 1932, § 131(b).

⁸⁸ I.R.C., § 904.

⁸⁹ The limiting fraction can never be more than 1, for the provision adds, in the case of the numerator, that it may never exceed the "taxpayer's entire taxable income," and this latter figure will always correspond to the denominator.

This fraction has three main features, the first of which is a direction to the effect that the numerator and the denominator be determined solely by reference to American tax concepts, foreign tax notions being irrelevant. One such concept, expressed quite clearly in both elements of the fraction, involves the term "taxable income."

The requirement, that the computation of this limiting fraction be guided exclusively by the American concept of "taxable income," comes into play only in calculating the *final ceiling* on credits, and must not be confused with certain other less demanding ideas which bear on *initial* computation of the credit—a matter governed by quite different provisions of the Code. Illustratively, one of these other provisions is to the effect that a credit will not normally be allowed in the first instance with respect to any foreign tax other than "income, war profits, and excess profits taxes." As is later more fully explained in Subsection 4, here too American ideas will be used in determining whether a given foreign tax measures up to the characterization, "income tax," but in this instance the test may be satisfied though the foreign levy does not conform precisely to American notions regarding gross income and deductions. Again, assuming this more general standard is satisfied in a given case, the *entire amount* of foreign income taxes paid or accrued may actually enjoy the credit though the foreign income tax law allowed more by way of deductions or did reach some items of income sourced there which the United States exempted or subsumed under a nonrecognition provision.⁹⁰ In other words, with respect to the credit, it is only *after* the initial computation, i.e., when one reaches the limiting fraction of the per-country limitation, that the American notion of "taxable income," and its precise standards regarding gross income, deductions, exemptions, nonrecognition provisions, etc., can affect the amount of the credit, and then only by way of establishing the ceiling.⁹¹ In the end,

⁹⁰ But in practice it has not always been so. A 1936 decision, *Hubbard v. United States*, (Ct. Cl. 1936) 17 F. Supp. 93, *cert. denied*, 300 U.S. 666, 57 S. Ct. 508 (1937), was to the opposite effect insofar as the foreign tax was attributable to an item which would not have been subject to taxation by the United States. But *Helvering v. Nell*, (4th Cir. 1944) 139 F.(2d) 865, and *I. B. Dexter*, 47 B.T.A. 285 (1942), *acq.*, C.B. 1948-2, 1, took a contrary view. And this was adopted for a time by the government in G.C.M., 25723, C.B. 1948-2, 131. Its subsequent modification of that ruling, in G.C.M. 26062, C.B. 1949-2, 110, was abandoned, however, in Rev. Rul. 54-15, C.B. 1954-1, 129, on the basis of the Tax Court's decision in *James H. Brace*, 11 T.C.M. 906 (1932).

⁹¹ However, in the case of individuals, estates, and trusts, I.R.C., § 904(b) provides that no allowances for personal exemptions can be taken under I.R.C., §§ 151 or 642(b).

however, this calculation may turn out to have been in vain, for the initially computed credit will stand as the final credit if the foreign tax actually paid or accrued turns out to be less than the per-country limitation. An illustrative case is one where the amount of the foreign tax paid or accrued equalled an *effective* rate of, say, 40%—as determined by reference to American notions of taxable income, with the effective rate in the States being higher. On the other hand, it is conceivable that the ceiling itself could be 0. Illustrative would be a case where the foreign operation would have operated at a loss except for an income item which, while taxed abroad, would be in an exempt class in the United States. In this event, the numerator of the limiting fraction would be 0, with the consequence that the fraction would become 0.

A second American tax concept relates only to the numerator of the limiting fraction and is implied from the interdependent structure of the Code; it is to the effect that American rules of jurisdiction will be employed for the purpose of determining that part of the taxpayer's taxable income which will be deemed to have its "source" in the particular foreign country.⁹² For example, prior thereto, it was possible that the United States and the foreign country would each claim to be the source of the profit made on an exported item. While the United States looked to the place where title passed in resolving this question,⁹³ other countries sometimes used a different test. And in that event, because of the applicability of American standards, it was possible that the numerator of the limiting fraction would be 0, thus foreclosing the opportunity to take a credit for the foreign tax.⁹⁴ The importance of this feature, in the case of those doing business with five Common Market countries with which the United States has a tax treaty, has been somewhat reduced by the adoption of those treaties. Pursuant to the tax treaties, the five Common Market countries have agreed to forego any tax on an American corporation's export profit except in the instance where that corporation is engaged in a trade or business through a permanent establishment situated in the foreign country in question.⁹⁵

In the setting of a foreign-subsidary arrangement, the two

⁹² In effect, I.R.C., § 904 incorporates the source rules of Subchapter N, particularly §§ 862 and 863.

⁹³ *U.S. v. Balanovski*, (2d Cir. 1956) 236 F.(2d) 298, *cert. den.*, 352 U.S. 968, 77 S. Ct. 357 (1957); *Comm'r v. East Coast Oil Co., S.A.*, (5th Cir. 1936) 85 F.(2d) 322; *cert. denied*, 299 U.S. 608, 57 S. Ct. 234 (1936).

⁹⁴ *Burk Brothers*, 20 B.T.A. 657 (1930).

⁹⁵ See PART II, *supra*.

American tax concepts incorporated in the numerator of the limiting fraction ("taxable income" from the foreign country, and the domestic rules fixing the source) will have one effect which can be easily overlooked as applied to the credit for foreign taxes paid on dividends. The Code provisions fixing the source of income in a foreign country deal first with the matter of *gross* income.⁹⁶ They then go on to provide that from such gross income, in arriving at "taxable income" from the foreign source, there shall be deducted the expenses, etc., "properly apportioned or allocated thereto, and a *ratable part* of any expenses, losses or other deductions which cannot definitely be allocated to some item or class of gross income."⁹⁷ The Tax Court has insisted that a part of the general administrative expenses of the parent corporation must be allocated to the dividend in arriving at the numerator of the fraction, and in this it has been affirmed on appeal.⁹⁸

Since foreign taxes normally will have been paid with a part of the foreign currency received in the course of operations abroad, questions relating to timing, as it affects the initial determination of income and credits for both cash receipts and accrual taxpayers, are considered, together with the conversion problem, in PART IV, *infra*. It should be noted here, however, that the per-country limitation creates a separate timing problem. The numerator and the denominator are calculated by reference to the accounting period used for *federal* tax purposes, and the limiting fraction is then applied to the credit for foreign taxes properly paid or accrued within *that* period. Because variation between the United States and the foreign country with respect to the matter of timing could, *inter alia*, lead the per-country limitation to spring into operation where it would not otherwise do so, three steps at the federal level have been taken.

The first involved congressional action; cash basis taxpayers were allowed to elect the accrual method for purposes of the credit, thus in general permitting such taxpayers to link the credit to the year foreign taxable income was earned.⁹⁹

The second step was accomplished by administrative action; a ruling was designed so as to accommodate the situation where the

⁹⁶ I.R.C., § 862(a).

⁹⁷ I.R.C., § 862(b). Italics added.

⁹⁸ *International Standard Electric Corporation*, 1 T.C. 1153 (1943), *aff'd*, (2d Cir. 1944) 144 F.(2d) 487, cert. den., 323 U.S. 803, 65 S. Ct. 560 (1945); *South Porto Rico Sugar Co.*, 2 T.C. 738 (1943).

⁹⁹ Rev. Act of 1924, §§ 238(c) and 222(c), now I.R.C., § 905(a). See PART IV, Section E, *infra*.

foreign tax was based on a fiscal year different from that of the American tax. In such case, those properly using the accrual method were permitted to accrue on a *pro rata* basis the foreign income tax for a particular foreign-tax year, allocating that tax between the two American tax years in which the foreign year fell.¹⁰⁰

There were still other timing matters which created fluctuations of a type prejudicial to a taxpayer because of the way the per-country limitation worked. Illustratively, for federal purposes, the taxpayer might have elected to report sales on the installment basis though such method was not permitted by the foreign government. Again, differences between the two countries in inventory practices or in depreciation methods could in effect lead to differences in the year in which profits would be reflected. The same difficulty could be encountered in connection with the fact that only the Netherlands permits a carry-back of net operating losses, and even that carry-back does not coincide in point of years with the practice followed in the United States. As indicated in PART I, most Common Market countries permit only a carry-over.

Problems such as these led a congressional committee in 1958 to conclude as follows:

Double taxation can occur at present because of the manner in which this country-by-country limitation works where the methods of reporting income are different in the United States and the foreign country. These differences may result in the same income being reported in one year in the United States and in another year in the foreign country. When this occurs the foreign tax credit available will tend to be less than the taxes paid or accrued to the foreign country in the year the income is reported in that country but not in the United States. In another year when this income is reported in the United States but not the foreign country, the credit which would be available under the limitation will tend to exceed the foreign taxes paid or accrued.¹⁰¹

It was for the asserted purpose of cushioning the impact of these difficulties that the committee induced Congress to adopt a new provision permitting a carry-back and carry-over of such portion of a foreign country's income tax as may exceed the ceil-

¹⁰⁰ I.T. 4033, C.B. 1950-2, 52.

¹⁰¹ H. Rep. No. 775, 85th Cong., 1st Sess. (1957), C.B. 1958-3, 811 at 837. The Committee also mentioned differences in fiscal years as an operating difficulty. On the one hand, it may have been questioning the vitality of the ruling in note 100, *supra*, or it may have been referring to cash basis taxpayers with respect to whom that ruling is inapplicable.

ing fixed by the per-country limitation. The excess may be carried back successively to the 2 prior years and then forward to the 5 succeeding years, being used in those years—provided election is made to take a credit rather than a deduction—to the extent the foreign taxes for such years are less than the amount allowable under the country-by-country limitation.¹⁰² Carry-backs to years beginning before January 1, 1958, are not permitted, however.

This carry-back and carry-forward was about as attractive as any cushion Congress might have provided with respect to an American company of the type assumed here, namely, one which established a facility in, and suffered the income tax of, *only one* foreign country. In fact, even before the adoption of this cushion, in cases where the total foreign effort involved only one foreign country, the effect of the per-country limitation was similar to that associated with the older, but for a time discarded, overall limitation. It was only where the American company, directly or indirectly, suffered income taxes of two or more foreign countries that a difference could arise with respect to the two types of limitation. The overall limitation quite generally permitted taxes of two or more foreign countries to be averaged, thus leveling out the highs and lows and making it less likely that the effective foreign rate would exceed the American rate. The discussion *infra*, in Sections E, F, and G of this PART, indicates that the same was and is true, oddly enough, with reference to multi-country operations carried on by certain organizational *forms* which come under the per-country limitation. That this is not so, however, with respect to other forms, and because one limitation is not consistently more advantageous than the other, furnished the reasons for the determination by Congress in 1960 to allow any domestic taxpayer to elect to submit its foreign tax credit to an “overall” limitation, rather than to the per-country limitation. Since such a shift will actually be meaningful only where the American taxpayer’s foreign operations spread across two or more foreign countries, the newly revived alternative overall limitation will be discussed later in connection with such settings, in Sections E, F, and G, *infra*.

SUBSECTION 2. INTEGRATING AMERICAN AND COMMON MARKET DIRECT TAXES RE PERMANENT ESTABLISHMENTS AND SUBSIDIARIES

(a) *Introductory note: need for caution in assessing comparative data.*—Section A of this PART indicated the reasons why

¹⁰² Tech. Amendments Act of 1958, § 37, now I.R.C., § 904(c).

one should not place too much stress on comparative data which can be presented in this kind of study regarding direct tax loads imposed by Common Market countries. For those reasons, as well as others, like caution is essential with reference to comparisons of the *integrated* direct tax costs, American and foreign, of doing business abroad. Assumptions previously made in looking only at foreign tax costs, including a specific set of facts, must also be availed of here. In addition, because the Internal Revenue Service has not published rulings identifying all of those Common Market taxes which will be deemed to satisfy the American credit provisions, some assumptions, based on analogy, must also be made with reference to this question.

The comparisons below deal first with the integrated direct tax costs incurred by an American corporation which conducts its foreign activity through a permanent establishment. The same comparison is then made in the setting of a foreign subsidiary arrangement. The story concludes with a comparison between these two arrangements.

As in Section B of this PART, it is assumed that the American company has only one foreign facility which earned \$400,000 (*before* direct taxes) on an investment of \$4,000,000. To facilitate comparison, it has again been necessary to assume that the Common Market countries and the United States would follow identical concepts with respect to income and deductions in arriving at the \$400,000 in *pre-direct tax* profit.

(b) *Comparing integrated direct tax costs in the setting of a permanent establishment.*—Since the income of a foreign permanent establishment is included in that of the American corporation whether or not remitted, the effective rate in the United States will always fix the *minimum* integrated direct tax cost of this kind of an arrangement. Normally, the total *direct* tax costs would actually exceed this in only two circumstances.

The first involves that situation where the effective foreign *income* tax rate, calculated as a percentage of the pre-direct tax profit of \$400,000, exceeds the effective American rate expressed in terms of that same base, in which instance the American tax would be completely neutralized by the direct credit which is allowed.

The second instance where foreign direct taxes may in effect establish the minimum borne by a permanent establishment involves those foreign countries which, in addition to an income tax, impose

other types of direct taxes which will not qualify for the American credit, being only deductible for U.S. tax purposes. In other words, the effective American tax rate fixes only the minimum *income* tax burden; other types of foreign direct taxes which do not qualify for the credit will constitute an additional direct tax burden to the extent not absorbed by the American treasury as a result of the deduction which presumably would be allowed under § 164 in arriving at the American tax base.

Only if the assumed permanent establishment is situated in Germany are *both* of these circumstances likely to be encountered. That both will arise in that setting rests on the two-country effect of Germany's three primary taxes, as follows:

(1) On the one hand, because the three-factor German enterprise tax is deductible from the pre-direct tax profit of \$400,000 in arriving at the amount subject to the regular German income tax rate of 49%, the *effective* rate of the latter, as applied to the pre-direct tax profit, is considerably less than 49%;

(2) On the other hand, the *profit* factor of that three-factor enterprise tax is itself an income tax,¹⁰³ and more than offsets the deductible effect of the whole, thus increasing the effective rate of the two-pronged German income tax, as applied to the \$400,000, almost to 52%; and

(3) While the other two factors of the three-factor German enterprise tax and the separate German 1% net wealth tax serve as additions to the final two-country income tax load, they also serve as deductions from the \$400,000 in arriving at the American tax base to which the *stated* 52% is applied,¹⁰⁴ the effect being to reduce the *effective* American rate to a point below 52% of the \$400,000 pre-direct tax profit and below the percentage absorbed by the two-pronged German income tax (the regular and the profit factor of the enterprise tax).

As a consequence of the foregoing, the total two-country income tax load is determined by the German pattern, to which must be added its net wealth tax and two factors of its enterprise tax, leaving less than 33% of the \$400,000 remaining after direct taxes.

If the setting is shifted to Luxembourg, that portion of the

¹⁰³ See discussion *infra*, Subsection 4(d) of this Section.

¹⁰⁴ Germany's 1% net wealth tax is not deductible, however, in computing that country's own income tax base as applied to the permanent establishment.

\$400,000 absorbed by the American income tax would not be exceeded by Luxembourg's two-pronged income tax (regular and profit factor of its enterprise tax). And this is so though the non-profit factors of the latter's enterprise tax and its net wealth tax would be deducted from the \$400,000 in arriving at the American tax base.¹⁰⁵ However, in calculating the total integrated or two-country direct tax costs, to the effective American rate which fixes the minimum *income* tax load, one must add the two Luxembourg direct taxes which fail to satisfy the credit, specifically, the non-profit factors of the enterprise tax and the net wealth tax, producing total integrated direct taxes equaling approximately 57% of the \$400,000.

Presumably, Italy's property tax would also fail to satisfy the American credit though it could be deducted from the \$400,000 in arriving at the American income tax base. In effect, that portion not absorbed by the United States treasury through the deduction would constitute an additional direct tax burden, for the effective American income tax rate would fix only the minimum income tax load. The total integrated direct tax costs of the assumed permanent establishment, if located in Italy, would then approximate 55% of the \$400,000.

If the foreign permanent establishment is just a sales office, the peculiar incidence of property taxes in the three countries mentioned above will be markedly reduced or perhaps completely eliminated. In the latter event, only the two-pronged German income tax rate schedule is likely to exceed the American rate and fix the ultimate total direct tax burden.

According to the earlier country-by-country survey and the comparisons in Section B, *supra*, the other three member nations, Belgium, France, and the Netherlands, do not impose significant property taxes, and since their effective income tax rates (30%, 50%, and 47%, respectively) do not exceed the effective American rate, the latter will equal the amount of the integrated direct tax costs.

(c) *Comparing integrated direct tax costs of foreign subsidiaries which retain all profits for expansion.*—If a foreign subsidiary retains all of its after-tax profits in order to facilitate expansion or discharge indebtedness, the integrated direct tax

¹⁰⁵ Since the profit factor of the Luxembourg enterprise tax is quite similar to that in Germany, it is assumed that the Service would consider the profit factor as an income tax for purposes of the credit. Cf. Rev. Rul. 59-208, C.B. 1959-1, 192.

costs will be confined to *foreign* taxes. In the absence of a dividend, the subsidiary's profits will not be included in those of the American parent; nor will the latter currently enjoy the deemed-paid credit with reference to the subsidiary's own income tax.

A comparison of the foreign direct taxes which would be imposed in this setting, if the facts were like those just assumed in the setting of permanent establishments, appears in Section B, *supra*, and can be summarized as follows:

	<i>Direct Taxes</i>		<i>Direct Taxes</i>
Belgium	27.47%	Italy	44.67%
France	50.	Luxembourg	51.67
Germany	69.95	Netherlands	47.

(d) *Comparing integrated direct tax costs of subsidiary arrangements where all after-tax profits are distributed.*—In the situation discussed above, where a foreign subsidiary *retained* all after-tax profits, Belgium provided the locale where the lowest total direct tax costs would be encountered. Subject to one caveat, that locale will retain its favorable position even through a later period when the subsidiary has matured to a point that *all* current after-tax profits are to be distributed. In contrast to the inter-country comparisons drawn above, those drawn below with respect to this later stage require an integration of American tax costs with the foreign direct tax costs. The isolated significance of this will be more discernible and distinctions between the two stages in the life-line of a subsidiary will also be more obvious if one indulges in the same assumptions here as there, including the fact that the subsidiary earns \$400,000 in pre-tax profits on property worth \$4,000,000.¹⁰⁶

The caveat mentioned earlier with respect to Belgium relates to an assumption, which must be made in the absence of a published ruling, to the effect that the Belgian withholding tax on dividends will be deemed, for purposes of the *direct* credit provision in the Code, to be an assessment against the American parent.

A combination of two factors continue to favor Belgium:

(1) According to earlier discussion, an income tax is the only really significant direct tax imposed against the subsidiary itself, and its effective rate (21.34%) comes close to that point

¹⁰⁶ Disregarded also is the fact that administrative overhead of the parent must be apportioned in part to the dividend, in computing the per-country limitation on the credit. See Subsection 1, *supra*, and Subsection 3, *infra*.

(26%) where the greatest benefit is reaped from the combined deemed-paid credit and exclusion enjoyed by the American parent with regard to that amount which the subsidiary devoted to foreign income taxes; and

(2) While Belgium imposes an even larger withholding rate (30%) against dividends (78.66% of pre-tax profits), the *direct* credit which presumably would be allowed with respect to this *entire* tax will, when coupled with the *deemed-paid credit* for the subsidiary's tax, approximate the tentative (pre-credit) 52% tax which the United States would impose on the dividend (78.66% of pre-tax profits).¹⁰⁷

As a consequence of the two foregoing considerations, total Belgian taxes, approximating 45%¹⁰⁸ of pre-tax profits, will come very close to being the total direct tax load in our assumed factual situation.

The importance of the first of the two foregoing considerations is illustrated by the fact that while the two Belgian income taxes, approximating 45% of pre-tax profits, are almost as great as the single 47% which the Netherlands would impose directly on the subsidiary in lieu of any withholding tax against the parent for dividends received, the *integrated* direct tax cost of doing business through subsidiaries in the two locales would actually differ by a slightly greater amount, provided it be assumed that the same income and deduction concepts prevail in America as well as in those two foreign countries. The 47% imposed by the Netherlands comes close to one of the extremes (52%) where the combined *exclusion* and *deemed-paid* credit for foreign income taxes yields the least benefit. In fact, after taking the deemed-paid credit, an American tax equal to more than 2½% of the subsidiary's *pre-tax* profit will remain, producing an integrated tax which absorbs almost 50% of the subsidiary's pre-tax profits.¹⁰⁹

France, the third and last country which, for all practical purposes, confines its direct taxes to those on income, would provide a less favorable locale, taxwise, than the Netherlands.

¹⁰⁷ Since the dividend is 78.66% of pre-tax profits, the tentative American tax at 52% would be 40.9% of the subsidiary's pre-tax profits against which a total credit of 40.38% of pre-tax profits could be taken.

¹⁰⁸ To the tax on the subsidiary (21.34% of pre-tax profits), one must add the withholding tax of 30% on the dividend (30% × 78.66 of pre-tax profits), being another 23.6% of the subsidiary's pre-tax profits.

¹⁰⁹ The American tentative tax (52% × 53% of the subsidiary's pre-tax profits) of 27.56% of pre-tax profits would be offset by a deemed-paid credit (47% × 53% of pre-tax profits) equal to 24.9% of pre-tax profits
100%

While the deemed-paid credit for the 50% tax which the former would impose on the subsidiary, when coupled with the direct credit for the 15% withholding tax on dividends,¹¹⁰ would wipe out the American tax liability, the two French taxes—standing alone—would absorb around 57% of the subsidiary's pre-tax profits.¹¹¹

While Italy ranked next to Belgium in providing a favorable direct tax climate during the period when the subsidiary *retained* all of its profits, during a later period of full distribution one ultimate consideration serves to eliminate the gap which existed in the earlier non-distributive stage between Italy and the then lower-ranking Netherlands, the two now being almost side by side. Whereas the percentage of pre-tax profits absorbed by *integrated* direct taxes in a Netherlands setting changed very little between the two stages, *integrated* costs associated with an Italian subsidiary will increase during the second or distributive stage by an amount approximating 7% of pre-tax profits. Responsibility for this fairly substantial increase can be traced ultimately to the addition of an American tax which will not be completely offset by credits even though American *income* taxes, approximating 29% of the subsidiary's pre-direct tax profits,¹¹² will actually be less than the total Italian *direct* taxes of 44.67% of pre-tax profits.

This ultimate result is in turn traceable to two limitations on the credit enjoyed by the American parent:

(1) While the Italian *direct* tax costs (44.67% of pre-tax profits) will remain constant through the two periods, that portion attributable to the Italian property tax (equal to 7.5% of pre-tax profits) cannot be credited against the American tax (approximately 29% of pre-tax profits) of 52% on a dividend which equaled 55.33% of pre-tax profits;

(2) Since Italy does not split its income tax assessments between a corporate tax and a withholding tax on dividends, imposing just the former, the deemed-paid credit only will be applied in offsetting the U.S. tentative tax on the dividend. As a consequence, the whole of the Italian income tax (37.17% of pre-tax profits)¹¹³ will not actually serve as a credit against

¹¹⁰ As in the earlier case of Belgium, it is again assumed that this tax will ultimately also be deemed a tax against the parent, not against the subsidiary.

¹¹¹ A 15% withholding tax on a dividend equal to 50% of pre-tax profits is equal to a tax on 7.5% of pre-tax profits.

¹¹² 52% on a dividend equal to 55.33% of the subsidiary's pre-tax profits equals 28.77% of pre-tax profits.

¹¹³ It is assumed that the Italian excess profits tax will also ultimately qualify for the credit.

the American income tax, for the deemed-paid credit is limited to that portion of the Italian income tax which was actually paid with respect to the *distributed* profit. The net effect: the deemed-paid credit¹¹⁴ will not even neutralize the whole of the 52% which the U.S. will impose on dividends.

Luxembourg and Germany, ranking, respectively, fifth and sixth during both stages in terms of tax attractiveness, provided account is taken of *integrated* direct tax costs, would share one problem encountered by Italy were it not for a compensating consideration. Both levy certain significant direct taxes which will not qualify for purposes of the credit allowed against the American income tax on the ultimate dividend. Nevertheless, in the case of subsidiaries located in those two countries, the total U.S. tax will be completely offset by credits. In part, this is due to the fact that, unlike Italy, both also levy a 15% withholding tax on dividends which, presumably, is *fully* creditable, dollar for dollar. The relatively high direct tax costs associated with subsidiary arrangements in Luxembourg and Germany during a period of full distributions is traceable then to their own direct taxes which, according to the earlier discussion in Section B, would absorb, respectively, 58.9% and 60.1% of pre-tax profits. These figures may be compared with *integrated* direct tax costs during this stage of approximately 45% of pre-tax profits in the case of a subsidiary located in Belgium, of approximately 50% in Italy and the Netherlands, and of 57% where France is the locale.

In conclusion, it must again be emphasized that the total integrated direct tax costs could change substantially if the subsidiary does not own substantial property; in that event, the integrated tax problems growing out of the foreign property tax imposed by three member nations would be eliminated.

(e) *Comparing integrated direct tax costs of subsidiary arrangements where 40% of after-tax profits are distributed.*—The circumstance where a foreign subsidiary distributes 40% of its *after-tax profits* obviously falls between the two previously discussed situations involving subsidiaries which (1) retained all, and (2) distributed all, current after-tax profits.

In terms of *integrated* direct tax costs, all countries but two retain the relative rankings maintained in the previously discussed

¹¹⁴ The deemed-paid credit would appear to be only 22.24% of pre-tax profits $(37.17\% \times \frac{55.33\%}{100\% - 7.5\%})$. For the purposes of this formula, the term accumulated profits would only be 92.5% of pre-direct-tax profits of \$400,000; the other 7.5% represents non-qualifying property taxes.

stage (full distribution) with reference to tax attractiveness. Italy and the Netherlands "swap" places, the former regaining by a margin of less than 1% the position it held during the first stage (no distribution), as the second most favorable locale tax-wise. In the case of every country, however, the integrated direct tax cost in this third stage falls in between that which would follow where all profits are retained and where full distribution is made. This is another way of also saying that the factors discussed in the previous sub-topic are also at work in this third stage, though to a lesser degree. And in this third stage, the *integrated* direct tax costs run from approximately 34% of pre-tax profits where the subsidiary is situated in Belgium¹¹⁵ to 67% where the locale is Germany,¹¹⁶ the Netherlands falling closest to the mid-point at 48%.¹¹⁷

(f) *Conclusion: Comparing a subsidiary-arrangement's integrated tax costs in all three stages with that of a permanent establishment.*—As previously indicated, the integrated or two-country direct tax costs of a permanent establishment would remain constant during all three stages, i.e., without regard to whether foreign profits are actually remitted. Table III L compares those costs with the approximate integrated direct taxes which would be encountered in all three stages of a subsidiary arrangement *provided* one indulges in the assumptions previously made.

¹¹⁵ Since the subsidiary's own Belgian tax is 24.9% of pre-tax profits, a dividend equal to 40% of the balance will run to 30.04% of pre-tax profits, and on the latter figure a 30% Belgian withholding tax will absorb another 9% of pre-tax profits. The U.S. tentative tax ($52\% \times 30.04\%$ of pre-tax profits = 15.62% of pre-tax profits) will be easily neutralized by the total of direct and deemed-paid credits, leaving the total Belgian tax of 33.9% as final tax cost.

¹¹⁶ The German direct taxes on the subsidiary itself (64.89% of pre-tax profits) leaves a dividend (40% of the balance) of 14.044% of pre-tax profits out of which the 15% withholding tax will absorb 2.1% of pre-tax profits, resulting in a total German tax of 67% of pre-tax profits. The U.S. tentative tax of 7.302% of pre-tax profits ($52\% \times 14.044\%$) will be neutralized by the total direct and deemed-paid credits even though a part of the German direct tax was other than an income tax.

¹¹⁷ The Netherlands tax on the subsidiary (47%) leaves a dividend (40% of the remaining profits) of 21.2% of pre-tax profits on which the U.S. tentative tax ($52\% \times 21.2\%$) would equal 11.02% of pre-tax profits. The deemed-paid credit would fall a little short of neutralizing that tentative tax, being only 9.964% of pre-tax profits.

TABLE III L

Locale	Permanent Establish- ment	Subsidiary Arrangement		
		All Profits Retained	40% of After- tax Prof- its Dis- tributed	All-After- tax Prof- its Dis- tributed
Belgium	52. %	27.5 %	33.9 %	45.5 %
France	52. %	50. %	53. %	57.5 %
Germany	67.4 %	70. %	67. %	60. %
Italy	55.6 %	44.7 %	47.3 %	51.2 %
Luxembourg	57. %	51.7 %	54.6 %	58.9 %
Netherlands ¹¹⁸	52. %	47. %	48. %	49.6 %

SUBSECTION 3. ALLOCATING INCOME AND DEDUCTION

ITEMS BETWEEN AMERICAN AND FOREIGN
OPERATIONS

(a) *Introductory note.*—Where an American enterprise conducts its foreign activities through a branch, i.e., through a non-separately incorporated permanent establishment, proper allocation of income and deduction items between the two operations is essential to the determination of the *foreign* tax base as well as the per-country limitation which has been imposed on the American credit for foreign income taxes. Except with reference to the latter limitation, the allocation problem in the branch setting is not usually as important to American taxation as it is to foreign taxation. The reason is attributable to the fact that net profits of the foreign branch's operation, *whether or not remitted*, will always be commingled with domestic profits in determining "taxable income" for federal income tax purposes.¹¹⁹ This is not so, however, where the foreign activity is conducted through a foreign subsidiary. In that setting, proper allocation can be just as important in establishing the tax base of the parent for American tax purposes, as it is in fixing the tax base of the subsidiary for foreign tax purposes. Here, too, the problem can affect the credit

¹¹⁸ For a description of changes which would take place in the Netherlands' tax structure pursuant to a bill now pending, see PART VI, Section A, *infra*.

¹¹⁹ See PART IV, Section B for the accounting aspects.

for foreign taxes. Indeed, it could ultimately even affect the parent company's basis for stock held in the foreign subsidiary.

Because the problems are slightly different in the two settings, and because there is some variation in the basic legal data through which the interested countries have sought to police the matter, the discussion below deals separately with branch and subsidiary arrangements.

(b) *Allocation between American operations and non-separately incorporated foreign permanent establishments.*—In the case of a foreign branch, the integrity of the per-country limitation on the American credit for foreign income taxes can be preserved only if the United States has the power to assure proper allocation of income and deductions between the domestic operation and that of the branch. One of the statutory provisions to which it can look is a sweeping catchall, for its allocation principles apply alike to divided operations which are wholly domestic, to those which are wholly foreign but split between two or more countries, as well as to operations partly domestic and partly foreign. Its earliest counterpart was inspired to a substantial degree, however, by related domestic and foreign operations actually conducted through a subsidiary rather than through a branch. In 1921, a congressional committee called attention to a practice designed to minimize the amount of income which would be subject to American rates, noting:

Subsidiary corporations, particularly foreign subsidiaries, are sometimes employed to "milk" the parent corporation, or otherwise improperly manipulate the financial accounts of the parent company.¹²⁰

The congressional enactment which followed,¹²¹ to the effect that the Commissioner could re-allocate income and deductions between "related trades or businesses" in order to reflect the true circumstances, was the forerunner of § 482 of the present Code. Today, the Commissioner's power to effect a re-allocation is said to exist whether or not the two trades or businesses are separately incorporated and whether they are organized in the United States or abroad. The power extends to gross income, deductions, credits, and other allowances, provided such re-allocation is necessary "in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades or businesses."¹²²

Complementing the foregoing wholesale type of provision are

¹²⁰ H. Rep. No. 350, 67th Cong., 1st Sess. 14 (1921).

¹²¹ Rev. Act of 1921, § 240(d).

¹²² I.R.C., § 482.

three sections of the code, §§ 861, 862, and 863, which—absent a superseding treaty—fix the source of income, identifying whether an item will be treated as domestic or foreign. On the income side, two of those sections deal with items which are allocated exclusively to one country or the other.¹²³ Both then go on to provide that expenses and other deductions shall be attributed to the income items on the same basis; in addition, however, there must be a proper apportionment of a “ratable part of any expenses, losses, or other deductions which cannot definitely be allocated to some item or class of gross income.”¹²⁴ The third provision, § 863, deals with income derived partly from within and partly from without the United States, including, e.g., sales abroad of personal property produced in the United States. In circumstances where this principle is applied, apportionment of expenses and deductions is also required. However, in the case of simple export arrangements, earlier discussion in PART II indicated that this third statutory provision (§ 863) was less important with respect to sales in foreign countries with which the United States has a tax treaty. By such treaties, the foreign countries have abandoned the right to tax an American enterprise's export profits except where it maintains a permanent establishment in the treaty country. Where such an establishment is maintained, those treaties would apply an allocation philosophy similar to that reflected in the sweeping provision now found in the previously mentioned § 482 of the Code.

Illustrative is the treaty with Belgium, which provides that “there shall be attributed to such permanent establishment the net industrial and commercial profit which it might be expected to derive if it were an independent enterprise engaged in the same or similar activities under the same or similar conditions.”¹²⁵ Unlike the other treaties, that provision—like certain rulings of the Service—goes on expressly to require such net profit to “be determined on the basis of separate accounts pertaining to such establishment.” The Belgian and French treaties, though not those with other member nations, also add what would otherwise seem to be the case in any event, namely, that the competent authority of a particular taxing state may rectify such accounts, if need be, in order to reflect the apportionment principle described above.¹²⁶ This recognition, that each state may make its own interpretation of the way the appor-

¹²³ I.R.C., §§ 861 and 862.

¹²⁴ I.R.C., §§ 861(b) and 862(b), interpreted in G.C.M. 7592, C.B. IX-1, 213.

¹²⁵ Art. IV(1). Accord, Art. III(3) of the German and Italian treaties, and Art. III(2) of the Netherlands treaty. *Cf.* Art. 4 of the French treaty.

¹²⁶ Belgian treaty, Art. IV(2); French treaty, Art. 4.

tionment principle applies to a given case, is theoretically cushioned by four of the treaties which expressly recognize the right of competent authorities in both countries to "lay down rules *by agreement* for the apportionment of industrial or commercial profits."¹²⁷

While the basic allocation provision in the treaties generally deals with net profits, three of the treaties add an express comment with regard to deductions. For example, the Belgian treaty authorizes a permanent establishment to avail itself of deductions "wherever incurred, insofar as they are reasonably allocable to the permanent establishment, *including executive and general administrative expenses so allocable.*"¹²⁸

(c) *Allocation between an American corporation and its foreign subsidiary.*—In the case of a foreign subsidiary which conducts all of its activity in one member nation, an allocation problem generally arises only in connection with inter-company transactions and dividends. A 1959 case, decided by the Tax Court, is illustrative of the former. There an American enterprise sought to deflect the great bulk of its profit on foreign sales to its foreign sales subsidiary. The latter was billed at a price which enabled it to enjoy 90% of the total profit whereas sales through independent commission agents were handled on a 20% commission basis. The Commissioner's power to re-allocate under the previously discussed § 482 of the Code was sustained.¹²⁹

Now, in the case of related corporations, tax treaties with five of the six member nations include language very much like that found in the earliest counterpart to § 482. For example, the Belgian treaty provides that if the parent company, "by reason of its participation in the management or financial structure" of a Belgian corporation "makes with or imposes on the latter enterprise, in their financial or commercial relations, conditions different from those which would be made with an independent enterprise, any profits which, but for those conditions, would have accrued to one of the enterprises may be included in the taxable profits of that enterprise subject to applicable measures of appeal."¹³⁰ The Amer-

¹²⁷ The quotation is from the German treaty, Art. III(5). Only the French treaty lacks a provision to this effect. Italics added.

¹²⁸ Art. IV(4). Also, German treaty, Art. III(4), and Italian treaty, Art. III(5). Italics added.

¹²⁹ Jesse E. Hall, Sr., 32 T.C. 390(1959). For a different kind of example, see *Asiatic Petroleum Corporation, Ltd. v. Comm'r.*, (2d Cir. 1935) 79 F. (2d), 234, *cert. denied*, 296 U.S. 645, 56 S. Ct. 248 (1935).

¹³⁰ Art. V. Cf. the allocation language in Revenue Act of 1921, § 1331(b); French treaty, Art. 5; and Art. IV of the German, Italian, and Netherlands treaties.

ican regulation construing that provision notes that its obvious purpose is to achieve "tax parity with uncontrolled" enterprises, and adds that the previously described § 482 of the Code will be followed in effecting the implementation.¹³¹

A slightly different kind of allocation problem arises in connection with dividends received by the parent. As noted elsewhere, by reference solely to American law, a proper portion of the parent's general administrative or overhead expenses must be allocated to the dividend in determining the amount of "taxable income" derived by the parent from the subsidiary.¹³²

SUBSECTION 4. SPECIAL PROBLEMS RE CREDIT FOR FOREIGN TAXES OF A FACILITY SERVING ONE MEMBER NATION

(a) *Introductory note.*—The more frequently recurring mathematical aspects of the American credit for those foreign taxes suffered by a facility serving *only* one Common Market country were dealt with in Subsection 1, *supra*. Within this same limited setting, the discussion below focuses attention on certain special substantive and procedural problems which may be encountered in connection with the credit. Following a description of the treatment accorded "delayed" distributions received by a parent from a foreign subsidiary, the discussion shifts to the fact that the *deemed-paid* credit will generally be available only where the payment received is in the nature of a "dividend." Thereafter, a quite different overall restriction, generally limiting both direct and deemed-paid credits to foreign "income, war profits, and excess profits taxes," is considered. This Subsection then concludes with a description of the requirements relating to the procedure to be followed in claiming a credit.

(b) *"Delayed" distributions from accumulated earnings and profits.*—Directors who declare a dividend just before the close of a taxable year normally contemplate that they are distributing profits of that year. But such a declaration might also be made in a loss year; the directors of a foreign subsidiary may have been unwilling to "pass" a regular dividend date because of the expectations of certain foreigners who held some shares in the American enterprise's foreign subsidiary. Dividends are also frequently declared

¹³¹ T.D. 6160, § 504.106.

¹³² *International Standard Electric Corporation*, 1 T.C. 1153 (1943), *aff'd.*, (2d Cir. 1944) 144 F. (2d) 487, *cert. denied*, 323 U.S. 803, 65 S. Ct. 560 (1945); *South Porto Rico Sugar Co.*, 2 T.C. 738 (1943).

in the early part of one year, it being contemplated that the distribution was of the preceding year's profits.

In circumstances such as these, for purposes of the *deemed-paid* credit it is necessary to determine which year's profit will be deemed to have been distributed. Only then is it possible to identify which year's foreign taxes are to be credited against the American tax liability on the dividend.

The enactment of the deemed-paid credit in 1918 was followed shortly thereafter by delegation of power to the Treasury to resolve this question of timing in each case, subject to two important limitations.¹³³ This same arrangement prevails today.¹³⁴

The first limitation is to the effect that dividends paid within the first 60 days of any taxable year are to be treated by the Secretary of the Treasury as having been paid from the accumulated profits of the preceding year or years "unless to his satisfaction shown otherwise. . . ." ¹³⁵ In all other respects, according to the second limitation, dividends are to be treated as having been paid from the "most recently" accumulated profits. This latter rule means that dividends declared in December 1960 in an amount exceeding the profits of 1960 will normally be deemed, *to the extent of the excess*, to have been paid first from profits of 1959, if any, and to the extent not absorbed by the accumulated profits of that year, then from those of 1958, etc. And to the extent the declaration was deemed to be from 1958 profits, the deemed-paid credit allowed at the time of the dividend in 1960 will normally relate to foreign taxes paid by the subsidiary on the 1958 profits. As a consequence, the deemed-paid credit attributable to the 1960 dividend could require separate computations with respect to the subsidiary's foreign taxes for 1960, 1959, 1958, etc., in order to determine for each of those years, pursuant to § 901, what portion of each particular year's tax was paid on the profit actually distributed.¹³⁶ In other words, to each of those years one first must *separately* apply the formula previously discussed in Subsection 1, *supra*, reading as follows:

$$\frac{\text{Foreign Tax Paid by Subsidiary for a Particular Year}}{\text{Share of 1960 Dividend Attributable to Profits of a Particular Year}} \times \frac{\text{Entire Accumulated Profits of That Particular Year}}{\text{Entire Accumulated Profits of That Particular Year}}$$

¹³³ Rev. Act of 1921, § 238(e).

¹³⁴ I.R.C., § 902(c).

¹³⁵ The problem of proof is illustrated by *P. H. Peavey & Co. v. U.S.*, (Ct. Cl. 1932) 73 Ct. Cl. 600, 55 F. (2d) 516.

¹³⁶ *General Foods Corporation*, 4 T.C. 209 (1944).

The results from those separate determinations are then aggregated for the purpose of determining the deemed-paid credit attributable to the 1960 dividend.¹³⁷

It will be recalled also from the earlier discussion in Subsection 1, *supra*, that the per-country limitation will require a further computation. But this will be less complex. Its limited purpose, to prevent the credit for a particular foreign country's tax on the distributed profit from offsetting American taxes on income derived from sources other than that foreign country, does not require the type of unscrambling essential to the original computation of the credit. The per-country ceiling on the *total* direct and deemed-paid credit¹³⁸ otherwise ascertained is determined by the same formula used where the subsidiary distributes dividends only from current profits,¹³⁹ namely:

$$\frac{\text{Parent's U.S. Tax on Entire Taxable Income}}{\times} \frac{\text{Total Dividends From Country Y}}{\text{Parent's Entire Taxable income}}$$

(c) *Extent to which the deemed-paid credit is limited to "dividend" situations.*—From 1918 to 1954, a deemed-paid credit could only be taken upon the receipt of a "dividend."¹⁴⁰ The significance of this limitation is illustrated by a decision of the Court of Claims to the effect that a parent corporation could not take such a credit in connection with liquidation distributions received from a subsidiary even though the distribution included previously accumulated profits on which the subsidiary had paid substantial foreign income taxes.¹⁴¹ The Code treats such payments as proceeds from an "exchange," rather than a dividend.¹⁴² And because this is so, the parent corporation will usually enjoy the preferential treatment accorded capital gains, i.e., a 25% rate on the realized *gain*,¹⁴³ rather than suffer the ordinary tax rate—assumed in this study to be 52%—on the *entire* proceeds. The Court of Claims, in restricting the deemed-paid credit in accordance with the literal language of the statute, was comforted by the supposition that Congress could not

¹³⁷ *Ibid.*; *Coca-Cola Co. v. U.S.*, (Ct. Cl. 1944) 101 Ct. Cl. 729, 55 F. Supp. 616.

¹³⁸ *United Shoe Machinery Corp. v. White*, (1st Cir. 1937) 89 F. (2d) 363.

¹³⁹ Note 136, *supra*, acq., C.B. 1946-1, 2; G.C.M. 24823, C.B. 1946-1, 246 revoking G.C.M. 20286, C.B. 1938-2, 223.

¹⁴⁰ Rev. Act of 1918, § 240(c), now reflected in I.R.C., § 902(a) through (c). The term "dividend" is controlled by the definition in I.R.C., § 316.

¹⁴¹ *Freeport Sulphur Co. v. U.S.*, (Ct. Cl. 1958) 163 F. Supp. 648, addendum, (Ct. Cl. 1959) 172 F. Supp. 462.

¹⁴² I.R.C., § 331.

¹⁴³ This assumes that the corporation is not collapsible. See I.R.C., § 341.

have intended to allow both this preferential treatment and a credit for foreign taxes.¹⁴⁴

Presumably the deemed-paid credit was not originally extended to cover *interest* payments because of the absence of a *double tax* problem with reference to such payments. Most foreign countries, including all Common Market nations, allow a subsidiary to deduct interest paid its parent, up to a reasonable amount, in arriving at the subsidiary's foreign tax base.¹⁴⁵ This is not to say, of course, that all member nations also immunize the *parent* with respect to the interest payment it receives. Indeed, in the typical situation, four of the six member nations will apply a withholding tax against the parent.¹⁴⁶ But in this circumstance, the *direct* credit is allowed,¹⁴⁷ dollar for dollar, subject only to the per-country limitation upon total credits attributable to income from the source country.

In 1954, for the first time, Congress did link the deemed-paid credit to a type of payment which a foreign subsidiary might be able to deduct in computing its own foreign tax base, specifically to "property" paid "in the form of royalty or compensation" for "property or services . . . furnished" by the parent to the subsidiary.¹⁴⁸

In this instance, however, three conditions, otherwise not applicable to the deemed-paid credit, must be satisfied:

(1) In contrast to dividend situations where the deemed-paid credit is allowed if the domestic corporation owns at least "10% of the voting stock"¹⁴⁹ of the foreign corporation from which it received the dividend, here the former must own, directly or indirectly, "100% of all outstanding stock" of the subsidiary;¹⁵⁰

(2) In contrast to the dividend situation where the deemed-paid credit is available without regard to the nature of a sub-

¹⁴⁴ In any instance where the deemed-paid credit would be more valuable than the preferential treatment accorded capital gains, the subsidiary might stagger the distribution, declaring a large regular dividend before proceeding with liquidation. But in such case, care must be taken or the Service may claim that all of the payments fall on the liquidation side of the line.

¹⁴⁵ See Section B, *supra*, and the country-by-country survey in PART I, *supra*, with reference to the French and German limitations.

¹⁴⁶ *Ibid.* Belgium and France are limited by treaty to 15% (Arts. VIII(A) and 6A, respectively); Germany must exempt such payments (Art. VII); Italy and Luxembourg are free to apply their respective national laws (26.32% and 5%, respectively); and the Netherlands own law does not normally provide for a tax except where the loan is secured by a mortgage on real property. *Cf.* its treaty provision, Art. VIII.

¹⁴⁷ Unlike the deemed-paid credit, the direct credit is available with respect to any income item, so long as the foreign country also exacted a qualifying tax.

¹⁴⁸ I.R.C., § 902(d). The congressional committee reports say nothing about the motive which led to this enactment.

¹⁴⁹ I.R.C., § 902(a).

¹⁵⁰ I.R.C., § 902(d)(1).

subsidiary's foreign business activity, covering even sales subsidiaries, this credit is extended here to the different type of payment only if the subsidiary is engaged in "manufacturing, production, or mining";¹⁵¹

(3) Here the property received as royalty or compensation must be pursuant to a contractual arrangement which must also provide that the payment "shall be accepted in lieu of dividends and that such foreign corporation shall neither declare nor pay any dividends . . . in any calendar year in which such property is paid to" the parent.¹⁵²

If these conditions are satisfied, then the property received by the parent shall be deemed a "distribution"¹⁵³ and ultimately a dividend—assuming the foreign subsidiary has adequate earnings and profits to pay such¹⁵⁴—to the extent of the *difference* between the value of that distributed and the cost to the *parent* of the "property or services so furnished" to the subsidiary.

By subsequently agreeing that the expression, "property" received, included *money*, the Internal Revenue Service has made this provision much more meaningful.¹⁵⁵ The Service has also properly called for a slight modification in the formula which is normally otherwise used in calculating the amount of the deemed-paid credit. The formula typically used,

$$\text{Foreign Taxes} \times \frac{\text{Dividend}}{\text{Subsidiary's Accumulated Profits Before Foreign Income Taxes,}}$$

contemplates that the denominator of the fraction will include the subsidiary's profits for the year *before* deducting its income, war profits, and excess profits taxes. In the case of this new special arrangement, the Service has ruled that the "dividend" portion of the royalty or other compensation must be restored to the denominator even though, pursuant to foreign tax law, it had been deducted by the subsidiary.¹⁵⁶ Illustratively, assume that a domestic parent received \$50 in service fees from a wholly owned foreign subsidiary, the full amount having been deducted by the latter for foreign in-

¹⁵¹ *Ibid.*

¹⁵² I.R.C., § 902(d) (2) and (3).

¹⁵³ Controlled by I.R.C., § 301 except with respect to the *amount* and *basis*.

¹⁵⁴ See I.R.C., § 316.

¹⁵⁵ Rev. Rul. 55-312, C.B. 1955-1, 80. This interpretation rested on the fact that § 902(d) is expressly made dependent upon I.R.C., § 301 which uses the term "property" as defined in I.R.C., § 317. The latter includes "money" in the definition.

¹⁵⁶ Rev. Rul. 59-71, C.B. 1959-1, 194, relying on the underlying philosophy of *Biddle v. Commissioner*, 302 U.S. 573, 58 S. Ct. 379 (1938), and the fact that, for purposes of the new § 902(d), a portion of the distribution is a "dividend" under *American* law, however it may be treated by foreign law.

come tax purposes, leaving it with \$500 in foreign income on which it paid foreign income taxes of \$200. The cost to the parent of the service extended to the subsidiary amounted to \$2. The deemed-paid credit would be computed as follows:

$$\text{\$200 Foreign Tax} \times \frac{\text{\$48 Dividend}}{\text{\$548 Accumulated Profit Before Taxes}} = \$17.50^{157}$$

As indicated in PART II, Section C, *supra*, subsidiaries in all Common Market countries may treat royalties paid a U.S. parent—for use of a patent, copyright, etc.—as a deductible business expense, but only to the extent the royalties are fair in amount and do not represent a hidden distribution of profits. One would certainly expect this limitation to be policed most carefully in those cases where the parent contractually commits itself, as it must under the new § 902(d), to accept the royalty “in lieu of dividends.” Moreover, in the unlikely event a subsidiary did succeed in deflecting *all* of its profit to the parent via deductible royalty payments, there would be no foreign income tax against which the new § 902(d) deemed-paid credit could be applied. This suggests that the new provision will be most useful over the long run in circumstances similar to the illustration above, where the subsidiary retained its own taxable profits for expansion, only a reasonable royalty having been paid to the parent during the taxable year. And in this case, again by reference to PART II, Section C, five of the Common Market countries are also precluded by treaty from withholding an income tax against the parent for the royalty it receives so long as (1) the royalty related to “the right to use copyrights, patents, secret processes and formulae, trade marks, and other analagous rights,”¹⁵⁸ and (2) the parent did not maintain a “permanent establishment” in the country in question.¹⁵⁹

(d) *Required characteristics of a foreign tax if it is to qualify for the credit.*—The credit for foreign taxes was originally confined to foreign “income, war profits, and excess profits taxes.”¹⁶⁰

¹⁵⁷ While a part of the parent's overhead entered into the calculation of the \$2 in cost, it may also be necessary, for purposes of the credit, to attribute another part of the parent's overhead to the collection of the dividend, in which case the latter would be less than \$48. *Cf.* International Standard Electric Corporation v. Comm'r., (2d Cir. 1944) 144 F. (2d) 487, *cert. denied*, 323 U.S. 803, 65 S. Ct. 560 (1945).

¹⁵⁸ PART II, Section C indicates those instances where coverage differs from this.

¹⁵⁹ PART II, Section C outlines the dispute which exists with reference to this question.

¹⁶⁰ Rev. Act of 1918, § 238(a)[1], now I.R.C., § 901.

In the middle of World War II, at a time when the United States had tacked an excess profits tax on to increased regular corporate rates, the Senate Finance Committee's attention was called to new tax patterns which had been developed in Latin America, this being the area to which American foreign trade had then become restricted because of war-time conditions.¹⁶¹ Several countries in that area had encountered difficulty in determining the portion of an American enterprise's profit which should be deemed to have its source there. In some cases, tax administrators there found it impractical to attempt to unravel deductions covering expenses alleged to have been incurred in the United States with reference to items exported into Latin America. In other instances, the difficulty related to the proper allocation of profit derived from items exported from Latin America to the States. International shipping operations also presented difficult allocation problems. Because of these difficulties, some of the Latin American countries substituted more simply designed special taxes for the income tax which the enterprise would have otherwise borne. While at least some of these levies were intended to produce an amount approximately equal to that which the Latin American country believed should have been produced by their income tax in a normal year, the formal character of the tax itself departed rather markedly from the typical net income tax which had evolved in the States. That formal difference led the Internal Revenue Service to deny that the taxpayer was entitled to a credit, arguing that American tax concepts controlled the meaning of the eligible categories, "income, war profits, and excess profits taxes."¹⁶²

The Senate Finance Committee,¹⁶³ and ultimately the Congress, responded to this problem by providing that the eligible category would also include "a tax paid in lieu of a tax upon income, war profits or excess profits otherwise generally imposed" by any foreign country.¹⁶⁴

This latter provision has been said to extend the credit to an otherwise ineligible foreign tax only if the foreign country has in force a general income tax to which the taxpayer would have been subject in the absence of a special immunizing provision.¹⁶⁵ More-

¹⁶¹ Statement of Mitchell B. Carroll, Hearings, Committee on Finance, 77th Cong., 2d Sess. (1942) Vol. 1, 206.

¹⁶² *E.g.*, note the government's position in *Seatrains Lines, Inc.*, 46 B.T.A. 1076 (1942), and its subsequent nonacquiescence to the decision reached there. C.B. 1942-2, 31.

¹⁶³ S. Rep. No. 1631, 77th Cong., 2d Sess. 47-48, 131-132 (1942).

¹⁶⁴ Rev. Act of 1942, § 158(f), now I.R.C., § 903.

¹⁶⁵ I.T. Regs., § 1.903-1(a).

over, the government insists that the statutory phrase, "a tax paid in lieu of" an otherwise eligible tax, means that adoption of the former tax must have been the *quid pro quo* for that freedom which the taxpayer received from the otherwise generally applied income tax.¹⁶⁶ In other words, there must be a link between the two; if the taxpayer's freedom from the general income tax was not attributable to its payment of a special foreign tax, the in-lieu-of provision will not apply. For example, the government denies that the provision covers German *turnover* taxes on royalties received from Germany even though such royalties were not subjected to the latter's income tax. The denial was grounded on the fact that freedom from the foreign income tax grew out of bilateral tax treaties designed to prevent double income taxation rather than out of any arrangement calling for substitution of a turnover tax.¹⁶⁷

Of more general interest than the in-lieu-of provision with respect to the Common Market is the problem of identifying those taxes which will be deemed "income taxes" under the original basic provision.

The courts have not fully agreed on the *underlying* standard or yardstick to be used in determining whether or not a given tax will be deemed an income tax. As previously noted, it is, on the one hand, definitively settled that American, rather than foreign, income concepts control,¹⁶⁸ and as a consequence the typical gross receipts tax will usually fall short of the mark.¹⁶⁹ For example, as was true of the German turnover tax,¹⁷⁰ the Service has indicated that the French registry tax imposed on the transfer of real estate by reference to the total purchase price is not eligible for the credit.¹⁷¹

At the other extreme, it is also generally recognized that the foreign tax need not coincide at all points with our *statutory* concept. For example, there may be some difference with respect to inclusions and deductions.¹⁷² Indeed if this were not so, the congressional aim in enacting the original credit provision would have been completely frustrated; all foreign income taxes differ in one degree or

¹⁶⁶ Rev. Rul. 56-635, C.B. 1956-2, 501. Cf. *Compania Embotelladora Coca-Cola, S.A. v. U.S.*, (Ct. Cl. 1956) 139 F. Supp. 953 with *Comm'r. v. American Metal Co.*, (2d Cir. 1955) 221 F.(2d) 134, cert. den., 350 U.S. 829, 76 S. Ct. 61 (1955).

¹⁶⁷ Rev. Rul. 56-635, C.B. 1956-2, 501.

¹⁶⁸ *Biddle v. Commissioner*, 302 U.S. 573, 58 S. Ct. 379 (1938).

¹⁶⁹ *Guantanamo & Western Railroad Co.*, 31 T.C. 842 (1959).

¹⁷⁰ See note 167, *supra*.

¹⁷¹ Rev. Rul. 56-507, C.B. 1956-2, 120. However, the tax may be deducted from gross income by the person against whom it is imposed. Also, see G.C.M. 8478, C.B. IX-2, 224. (1930) re a special French turnover tax.

¹⁷² *Helvering v. Campbell*, (4th Cir. 1944) 139 F.(2d) 865; I.T. 4074, C.B. 1952-1, 87.

another from the American statutory version. Uncertainty necessarily increases, however, as the differences become more marked; for example, what result should be reached if the foreign tax reaches gross income as distinguished from gross receipts, provision not having been made for any of the more important deductions? One court, pointing to the fact that the Sixteenth Amendment had been held to embrace *gross* income, indicated that it was perhaps enough that this *constitutional* norm be satisfied.¹⁷³ To this decision, however, the government filed a non-acquiescence.¹⁷⁴ On a later occasion, the same court talked as though the American *statutory* concept really constituted the basic point of reference,¹⁷⁵ only thereafter to see the Service exclude a Mexican tax because "liability for the tax arises at the time the operation to the tax takes place, whether or not income in the [American] *constitutional* sense results."¹⁷⁶ Interestingly enough, these twists and turns came after the Supreme Court, while deciding a related but admittedly different question arising out of the credit provision, had stated in *Biddle v. Commissioner*:

The phrase "income taxes paid," as used in our revenue laws, has for most practical purposes a well understood meaning to be derived from an explanation of the *statutes* which provide for the laying and collection of income taxes. It is that meaning which must be attributed to it as used in § 131 [now I.R.C., § 901 et seq. governing foreign tax credits].¹⁷⁷

That Court actually had before it a question which will be common, though quite probably less prejudicial, to all of the Common Market withholding taxes on dividends. The issue was whether an individual stockholder, at the point of receiving a dividend, was entitled to a *direct* credit for his equitable share of the *regular* corporate tax suffered by the distributing company at the time its profits were earned. While the stockholder, pursuant to British surtax provisions, "grossed up" the dividend by also including in his gross income an allocate share of the corporate tax and then credited the latter against his British surtax, the Court denied him an *American* tax credit for his portion of the British corporate tax. That American tax laws—the basic yardstick—did not attribute taxes assessed

¹⁷³ *Seatrains Lines, Inc.*, 46 B.T.A. 1076 (1942).

¹⁷⁴ C.B. 1942-2, 31.

¹⁷⁵ See *Lanman & Kemp-Barclay & Co. of Columbia*, 26 T.C. 582 (1956); *L. Helena Wilson*, 7 T.C. 1469 (1946).

¹⁷⁶ Rev. Rul. 58-3, C.B. 1958-1, 263 at 264.

¹⁷⁷ 302 U.S. 573 at 579, 58 S. Ct. 379 (1938).

against the corporation to stockholders as such was said to be decisive.

While the principle of the *Biddle* case, as applied to the United Kingdom, was subsequently modified by treaty,¹⁷⁸ the point decided there is still relevant to Common Market *withholding* taxes on dividends paid by subsidiaries or by their sub-subsidiaries. Unless foreign law treats those taxes as assessments against the *distributee*, withholding serving as a collection device, so-called dividend taxes paid by a foreign subsidiary on dividends distributed to the American parent will come under the *deemed-paid* credit provision, if any, rather than under the direct credit provision.¹⁷⁹ And in like fashion, the dividend tax withheld by a sub-subsidiary would come under the special deemed-paid credit arrangement applicable to a sub-subsidiary's own tax, and would not be treated as a part of the distributee-subsubsidiary's own direct tax liability.¹⁸⁰

The same type of problem arises, of course, in connection with the deduction allowed for other foreign taxes. For example, a foreign stamp tax is deductible only by the person against whom the tax is imposed, even though another may actually suffer its economic burden.¹⁸¹

Unfortunately for those engaged in tax planning, the Internal Revenue Service has not published many rulings directly responsive to the foregoing questions in the setting of Common Market taxes. This may be due to its realization that, at least *theoretically*, such rulings would have a relatively short effective life in that each amendment of a given foreign tax law would require reconsideration of the government's position even though, in the end, it might not be changed.¹⁸² In any event, the paucity of published rulings plus the possibility that amendments to a foreign law might lead the government to reconsider its position suggest that one engaged in planning should, after making preliminary comparisons, seek advance rulings before tentative plans are finalized.

In this connection, a final common problem involves the multiple

¹⁷⁸ Article XIII; Rev. Rul. 56-289, C.B. 1956-1, 321.

¹⁷⁹ Cf. Rev. Rul. 56-289, C.B. 1956-1, 321.

¹⁸⁰ The credit arrangement, as it bears on a sub-subsidiary, is discussed in Section E, Subsection 2, *infra*.

¹⁸¹ Rev. Rul. 56-507, C.B. 1956-2, 120. In holding that the French registry tax fell into the deductible category, the Service avoided deciding on which person the tax was imposed, saying only that it was deductible by the person who properly paid it.

¹⁸² E.g., since the last published ruling on the Netherlands income tax as applied to dividends (I.T. 3371, C.B. 1940-1, 102), the tax pattern of that country has been changed.

base Common Market enterprise or trade taxes. On the one hand, as previously noted, full credit—subject only to the per-country limitation—may be enjoyed though the foreign tax includes within its base some items which the United States does not in fact tax as income.¹⁸³ For example, the Cuban income tax was not disqualified even though it reached stock dividends,¹⁸⁴ an item not in fact taxed by the Internal Revenue Code¹⁸⁵ and perhaps even constitutionally beyond its reach.¹⁸⁶ In explaining its favorable position in such cases, the Internal Revenue Service has said:

When such a *unified* tax is imposed by a foreign country, its predominant character will determine whether the tax is an income tax and credit will be denied for the *entire* amount or allowed for the *entire* tax subject to the limitations of section 904 of the Code [the per-country limitation].¹⁸⁷

This “all-or-nothing” notion, geared to a balancing of the competing characteristics, will not be applied, however, if the foreign assessment does not actually rest on a unified interdependent tax base. Both the Tax Court and the Service have unraveled a multiple base foreign assessment, qualifying the income tax component while rendering ineligible the non-income tax factors.¹⁸⁸ One such instance involved the German three factor enterprise tax, credit being allowed for the profit factor but not for that portion of the assessment representing taxes on capital employed in the business and on wages paid.¹⁸⁹

¹⁸³ *Helvering v. Campbell*, (4th Cir. 1944) 139 F.(2d) 865.

¹⁸⁴ I.T. 4074, C.B. 1952-1, 87.

¹⁸⁵ I.R.C., § 305.

¹⁸⁶ *Eisner v. Macomber*, 252 U.S. 189, 40 S. Ct. 189 (1920). But see discussion to the contrary in Wright, *The Effect of the Source of Realized Benefits upon the Supreme Court's Concept of Taxable Receipts*, 8 STAN. L. REV. 164 (1956).

Contrary to the rationale of the stock dividend ruling was the decision denying a credit to that part of a British income tax assessment based on the “annual value” of real property. *Woolworth Co. v. U.S.*, (2d Cir. 1937) 91 F.(2d) 973, cert. den., 302 U.S. 768, 58 S. Ct. 481 (1938). An earlier decision had allowed a credit for a somewhat similar tax imposed in France. *Herbert Ide Keen*, 15 B.T.A. 1243 (1929), approved in I.T. 2485, C.B. VIII-2, 252. Cf. denial of the credit for a so-called income tax imposed by Canada on a legacy, *L. Helena Wilson*, 7 T.C. 1469 (1946).

¹⁸⁷ Rev. Rul. 56-51, C.B. 1956-1, 320. Italics added.

¹⁸⁸ *Lanman & Kemp-Barclay & Co. of Columbia*, 26 T.C. 582 (1956) re a multiple base income and property tax; Rev. Rul. 56-51, C.B. 1956-1, 320.

¹⁸⁹ Rev. Rul. 59-208, C.B. 1959-1, 192. The regular German corporate income tax was viewed favorably credit-wise in I.T. 4026, C.B. 1950-2, 51; in Rev. Rul. 59-56, C.B. 1959-1, 737 as applied to income derived from cutting and selling timber.

While the general income tax in Italy, known as “RM,” was approved for credit

(e) *Procedure in initially claiming the credit.*—The Treasury designed Form 1118 as the device by which to secure from corporations that information deemed essential to allowance and computation of the credit.¹⁹⁰ In claiming a credit for foreign taxes already paid, the receipt or sworn copy,¹⁹¹ together with an accurate translation, must accompany the form. In the absence of a receipt, secondary evidence—such as a photostatic copy of the check or draft—will suffice.¹⁹² In the case of foreign taxes withheld from dividends, etc., secondary evidence—including submission of evidence relating to the foreign country's rates and withholding procedures—may be submitted absent direct evidence of the withholding.¹⁹³

Normally an appropriate copy of the foreign return must accompany Form 1118 if claim is made for *accrued* but unpaid foreign taxes.¹⁹⁴ Excerpts from the taxpayer's accounts may serve, however, as a substitute if need be.

The immediate future is likely to see some change in the amount and type of information which must be furnished. In late 1960, Congress adopted an additional policing measure, clearly establishing the right of the government to obtain from domestic parents certain types of information relative to their foreign subsidiaries and sub-subsidiaries, which information the Treasury had always had the clear right to obtain with reference to foreign branches.^{194a} Included among the types of information which the Treasury may require are explanations regarding inter-company transactions, balance sheets, and analyses of accumulated earnings and profits covering even inclusions, deductions, etc. At this writing, regulations implementing the new provision have not been issued.

Finally, with reference to accrued foreign taxes, the District Director may also condition allowance of the credit upon the submission of a proper bond.

Conversion problems as they affect the credit, and questions relating to the use of the cash and accrual methods, are dealt with in Section E of PART IV.

purposes in S.M. 1614A, C.B. IV-2, 203 (1925), certain other Italian taxes were denied the benefit of a credit in S.M. 3982, C.B. IV-2, 204 (1925).

¹⁹⁰ I.T. Regs., § 1.905-2 also prescribes that Form 1116 will be used by individuals.

¹⁹¹ Or a certified or authenticated copy. I.T. Regs., § 1.905-2(a)(2).

¹⁹² I.T. Regs., § 1.905-2(a)(2) and (b)(1).

¹⁹³ I.T. Regs., § 1.905-2(b)(3).

¹⁹⁴ A duplicate original or a certified, authenticated or sworn copy. I.T. Regs., § 1.905-2(a)(2).

^{194a} Pub. Law 86-780, 86th Cong., 2d Sess. (1960), § 6, adding a new § 6038 to the Code, the old § 6038 being renumbered as § 6039.

SECTION D. FURTHER FOREIGN AND AMERICAN TAX
EFFECTS WHERE FOREIGN PERMANENT
ESTABLISHMENT OR SUBSIDIARY IN ONE
MEMBER NATION EXPORTS DIRECTLY TO
CUSTOMERS IN ANOTHER

(a) *Introductory note.*—In developing plans for marketing a product in more than one member nation, an American enterprise may well consider, *inter alia*, creation of a foreign permanent establishment or subsidiary in one country with the expectation that it will also export directly to customers in one or more other affiliates of the Common Market. Potential tax implications of such an arrangement depend on: (1) whether the export profits will be taxed by more than one member nation; (2) whether multiple turnover taxes will be encountered; (3) whether one country, as distinguished from another, offers a more favorable direct tax climate; and (4) the extent to which the increase in foreign taxes, if any, will serve further to reduce American tax liability. These questions are considered separately under the sub-topics which follow.

(b) *Extent to which export profits will be taxed by the importing as well as the exporting member nation.*—Under the respective national laws of member nations, the exporting country in which the permanent establishment or subsidiary is located will, of course, reach the entire profit made from direct export operations. For a comparison of the direct tax load which each member nation would impose if it were the exporting country, see the discussion and charts in sub-topics (b) and (c) of Section B, *supra*.

With regard to the importing country, it should be noted at the outset that the Common Market arrangement does not include a multilateral tax treaty dealing with double taxation. Only bilateral arrangements exist. The status of treaties of this sort is reflected in Table III M.

Under the treaties in force or concluded but not yet ratified, the importing countries will respond in a manner similar to that provided for in other bilateral tax treaties to which the United States is a party. This means, according to the more detailed discussion in PART II *supra*, that the importing country will not attempt to reach any part of such profits unless a permanent establishment or subsidiary has been established in the importing country.

The chart on the next page indicates that a treaty between

TABLE III M
TREATY STATUS CHART

<i>Meaning of Symbols</i>						
F—In force						
C—Concluded but not yet in force						
				OFC—Old treaty in force, but to be replaced by new treaty which is concluded but not yet in force		
				N—Under negotiation		
				NONE—Treaty not even under negotiation		
	Belgium	France	Germany	Italy	Luxembourg	Netherlands
Belgium	—	F	N	F	F	F
France	F	—	OFC	OFC	F	F
Germany	N	OFC	—	F	F	F
Italy	F	OFC	F	—	NONE	C
Luxembourg	F	F	F	NONE	—	NONE
Netherlands	F	F	F	C	NONE	—

Luxembourg, on the one hand, and Italy and the Netherlands, on the other, is not even under negotiation. Accordingly, where the former or the latter receives imports from the other, direct taxes imposed by the two countries would depend entirely upon the character of their respective national laws. However, in the case of exports between Luxembourg and the Netherlands, the tax effect is quite similar to that which would follow under a typical treaty. While the exporting country will reach the entire profit, the importing country will not assess direct taxes if a permanent establishment has not been created there. A different consequence follows in the case of exports from Luxembourg to Italy. The latter, as the import country, will impose its income tax whether or not a permanent establishment exists there, provided the exporter is active in Italy in a regular and habitual manner. While Luxembourg, as the exporting country, will also tax the entire export profit, it will allow a deduction against income for the amount of Italian taxes paid, if any.

(c) *Extent to which exports from one member nation to customers in another will encounter multiple turnover taxes.*—Generally speaking, as distinguished from customs duties, the turnover tax imposed by a member nation at the point of import will not vary

by reference to the different countries from which the goods could have originated. Illustratively, the turnover tax imposed by Italy at the point of import will be the same whether the goods originated in the United States or in France. The one exception grew out of a special formal economic relationship which includes Belgium and Luxembourg. Pursuant to that arrangement, Belgium has agreed to forego the increased turnover tax which it would otherwise assess at the point products are imported from Luxembourg.

Earlier discussion in Section B of PART II indicated in some circumstances that certain import countries (Netherlands, Germany, Luxembourg, and France) may assess one turnover tax at the point of import and another at the point of delivery. In the Netherlands, for example, reservation of title up to the point of actual delivery will lead to a second taxable event (normal rate .75% at the point of delivery). The same result will follow in Luxembourg and Germany if the goods are transported by the exporter's own vehicles (2% and 4% applied, respectively, if exporter was the manufacturer or if he delivers the goods directly to private consumers). The earlier mentioned discussion in Section B of PART II, *supra*, also explores various means by which the second taxable event might be avoided. While arrangements relating to delivery in France can also theoretically complicate the turnover tax problem, the end result is less serious there because France's tax is essentially one on added value with the consequence that the tax paid on a second taxable event will be offset by a credit for the tax paid on the first taxable event.

In all member nations, the exporting country will allow the export transaction itself to be exempt from its turnover tax. But only four of them (Netherlands, Germany, France, and Italy) quite generally provide some kind of refund for turnover taxes paid in connection with earlier transfers in the course of which the product was created. While the German formula for computing the refund is less exact than that of the Netherlands, in general both refund the turnover taxes previously paid when the exporter bought the goods or the raw materials out of which he manufactured the goods or, if imported by him, they refund the tax paid on that occasion. Under the French system, on the other hand, the entire turnover tax burden previously suffered by the product will be refunded, as well as that portion of turnover taxes borne in connection with the acquisition of capital goods which were used in manufacturing the exported item. Administratively, it is easier for the French to calculate and refund

the exact amount of turnover taxes previously borne by a product. Under its turnover tax system, records of taxes previously borne must be kept quite generally, for these serve as a credit against the gross tax due at later stages, the aim being to reach only the value added at any given stage. Finally, in Italy, factors reflecting a rough approximation of turnover taxes previously paid are used in determining refunds allowed on special lists of various types of goods.

Belgium does not attempt at the point of export to make restitution of any turnover taxes previously paid. However, it is possible to import goods or raw materials into Belgium tax free if they are ultimately destined for export.

Luxembourg provides a modest restitution (.5%) at the point of export only in the case of certain metallic products.

(d) *Conclusion: Foreign tax factors to consider if a foreign permanent establishment or subsidiary is to engage in direct export to customers in other member nations.*—All other things being equal, differences in the direct tax structure of member nations may well affect the location of a foreign permanent establishment or subsidiary if it is also expected to export directly to customers in other member nations. But in assessing the significance of direct tax differences, the American enterprise may not be going far enough, at least theoretically, if it compares just those burdens which each member nation would impose if it were the *exporting* country. Consideration should also be given to differences which may appear if each were placed in the position of being an *importing* country, instead of being the home of the permanent establishment or subsidiary. The possible importance of this last feature is illustrated by a case where Italy is to be a significant market. In that event, Luxembourg would suffer one disadvantage, at least in principle, if it were considered as the potential site for the permanent establishment or subsidiary. It does not have an income tax treaty with Italy. And as noted in sub-topic (b) *supra*, in some circumstances Italy, as an import country, would apply its income tax to the trade profit. And Luxembourg would take account of the Italian direct tax only by allowing a deduction from gross income, as distinguished from a credit against the Luxembourg tax itself.

In choosing the site for the permanent establishment or subsidiary, it is also necessary to compare turnover taxes of each member nation, not just in terms of its possible role as an export nation, but also by reference to its practices if cast in the role of an import nation. For example, from an export standpoint, France offers the

most attractive turnover tax arrangement, because in principle all turnover taxes paid prior to export are refunded. Thus on the export side, a permanent establishment or subsidiary located there would encounter only the turnover taxes of those member nations into which goods are imported. While on this same count, the Netherlands and Germany constitute a close second and third to France, Luxembourg would again, at least in principle, provide the least attractive site. Turnover taxes paid there prior to the export transaction itself are not refunded except in a limited amount in the case of certain metallic products.

The foregoing discussion of direct as well as turnover taxes indicated that, *in principle*, Luxembourg suffered certain tax disadvantages as an export nation. In making comparisons, however, care must be taken to distinguish disadvantages in principle from those in fact. The two previously mentioned circumstances regarding Luxembourg are in point. While it does not have an income tax treaty with Italy, and though profits on exports to Italy might be taxed twice in some circumstances, the prejudicial circumstances are not in fact very great. Again, while Luxembourg does not refund turnover taxes paid prior to the export transaction, it will be remembered from the discussion in Section B of this PART that, comparatively speaking, turnover taxes in Luxembourg are not very high. Moreover, as previously mentioned in this Section, exports from Luxembourg to Belgium enjoy particularly favorable turnover tax treatment in the latter nation.

The difference between a disadvantage in principle and one in fact can also be illustrated by the problem of resolving ambiguities in the bilateral income tax treaties. In principle, the interpretative process in France is less attractive than that of certain other countries from a taxpayer's viewpoint. There, more or less final interpretations are made by an administrative department, rather than by the courts. In the general run of cases, however, it is not believed that the effect has in fact been unfavorable.

(e) *Extent to which the importing member nation's taxes will serve to reduce American tax liability.*—According to the previous discussion, the *importing* member nation will not normally impose an income tax on any portion of the profits derived in the exporting member nation from simple export arrangements. Therefore, the export arrangement will not normally *further* complicate the computation of either the deemed-paid or direct credit for foreign income taxes in determining American tax liability, if any. The

credit for income taxes paid the exporting member nation will be available and determined, of course, in accordance with the principles described in Section C, *supra*. Subsection 2 of Section E, *infra*, will indicate the complication which will arise should the importing nation assess an income tax because it determines that a permanent establishment was in fact created therein or if, as in Italy—with respect to imports from Luxembourg, it is determined that the exporter was locally active in a regular and habitual manner.

To the limited extent the export arrangement may give rise to multiple turnover tax liability, prices will be increased or profits reduced. If a subsidiary corporation handled the export from the first member nation, that part of its gross profit devoted to the increased turnover tax liability, if any, will never be declared as a dividend and as a consequence will never be brought into the American parent's gross income.

If, on the other hand, the exports were from an American corporation's branch or permanent establishment in the first member nation, the increased turnover tax liability would be deducted in computing American "taxable income," provided the liability was actually asserted by the foreign nation against the exporter and not against the importing vendee.¹⁹⁵

SECTION E. FURTHER TAX IMPLICATIONS IF A FOREIGN OPERATING SUBSIDIARY IN ONE MEMBER NATION CREATES ITS OWN PERMANENT ESTABLISHMENT OR SUBSIDIARY IN ANOTHER MEMBER NATION

SUBSECTION I. FURTHER FOREIGN TAX IMPLICATIONS

(a) *A foreign subsidiary creates a permanent establishment in another member nation: The direct tax problem.*—The discussion in Section D, *supra*, indicated that export profits realized by a subsidiary domiciled in one member nation would not normally be taxed by other member nations to which the products were exported. However, if the exporting subsidiary goes on to create its own permanent establishment in the importing member nation, the latter's income tax will quite generally be applied to that part of the total profit which is properly attributable to the permanent establishment. While there are minor variations in bilateral tax treaties

¹⁹⁵ The problem associated with the "liability" question is illustrated in Rev. Rul. 56-507, C.B. 1956-2, 120.

and relevant national laws with regard to the standards which will be applied in determining whether a permanent establishment has been created, reference to the general discussion of definitions in Section A of PART II and Section B of this PART must suffice for purposes of this study. Reference is also made to Section B of this PART for a comparison of the direct tax loads which each Common Market country would impose on such an establishment if subject to its jurisdiction.

The more important question is whether the profit of that permanent establishment will also be taxed by the quite separate domicile of the foreign subsidiary which created it. Such a second tax is one of the targets of bilateral tax treaties which are in force, or have been executed but not ratified, between various European countries. The status of those treaties is indicated in Section D, *supra*. Under such treaties, where the domicile of the subsidiary has a progressive rate structure (see PART I), the usual scheme is for that country to take account of the foreign permanent establishment's profit only for the purpose of determining the rate bracket on the subsidiary's other income. In short, the applicable percentage figure is determined by reference to the *total* income, but is actually applied only with reference to income other than that earned by and attributable to the foreign permanent establishment.

In the absence of a treaty precluding double taxation, one must look to unilateral provisions, if any, to mitigate the double tax possibility. Belgium, Germany, and the Netherlands have incorporated such in their national laws. Belgium reduces by $\frac{4}{5}$ ths the normal rate which it would otherwise apply under its professional tax to the income of the foreign permanent establishment. Germany responds to the problem by allowing a tax credit. The same could be said with respect to the Netherlands, though relief there will normally be more favorable, leading in most instances to an exemption of foreign profits. Theoretically, the Netherlands would compute the amount of the credit without regard to the *actual* tax burden assessed on the foreign income by the other member nation. The credit would be determined by reference to the amount of the Dutch tax rate on the foreign income. As a practical matter, this generally relieves the foreign profit from the Dutch tax, for the Dutch rate schedule has little progression.

Although France does not have any *specific* unilateral relief provisions, the result there (and to some extent in Italy) will correspond for all practical purposes to the situation in the Netherlands,

for in principle only profits from domestic sources are taxed by France.

As previously indicated, any member nation in which the permanent establishment is located would apply its regular tax load to the income attributable to the establishment. Table III N indicates the instances where the domicile of the subsidiary which created the establishment would free that same income from double taxation, either through operation of a bilateral treaty or unilateral provision. The expression, "tax free," is used in Table III N in a more or less loose sense. In the instance where the domicile of the subsidiary has a progressive tax, that expression ("tax free") is used even though the domicile of the subsidiary would take the foreign profit into account in determining the rate which would be applied to the subsidiary's other income.

Immunity which might otherwise exist from a double tax will be prejudiced, of course, if the two countries do not allocate the overall profit in the same fashion. When this problem is encountered, the matter must be thrashed out with the proper tax authorities, for determination of a proper allocation is largely a question of fact.

(b) *A foreign subsidiary creates its own subsidiary in another member nation: The direct tax problem.*—If the first operating subsidiary which the American enterprise created in one of the Common Market countries (assume country A) establishes its own second tier subsidiary in yet another member nation (assume country B), the profits earned by the second tier subsidiary (No. 2) will be taxed to it only by country B, its domicile. Direct taxes which each member nation would impose on that second subsidiary if domiciled therein are compared in Section B, *supra*. Account is also taken there of differences which may arise in subsidiary No. 2's own tax load depending on whether its profits are retained in whole or in part.

At that point when the second subsidiary distributes profits in the form of dividends, there is the further question of whether both countries will assess a tax against the *recipient*, subsidiary No. 1. Any tax imposed on the latter by the *distributing* subsidiary's domicile would, of course, be handled on a withholding basis, as in the case of other non-residents. Table III O indicates whether and to what degree the two countries would seek to tax the recipient by reference to the dividend.

In determining the total direct tax costs, the tax exacted from the recipient of the dividend must be combined with the tax load orig-

TABLE III N

<i>Location of Subsidi- ary's Foreign Permanent Establishment</i>	<i>Tax Imposed by the Domicile of the Subsidiary on Income of Foreign Permanent Establishment</i>							
	Belgium	France	Germany	Italy	Luxembourg	Netherlands		
Belgium	—	Tax Free	Tax Credit	Tax Free	Tax Free	Tax Free		Tax Free
France	Tax Free	—	Tax Free	Tax Free	Tax Free	Tax Free		Tax Free
Germany	Decreased Rate	Tax Free	—	Tax Free	Tax Free	Tax Free		Tax Free
	Tax Free	Tax Free	Tax Free	—	Fully Taxed ¹⁹⁷	Tax Free		Tax Free
Luxembourg	Tax Free	Tax Free	Tax Free	Tax Free ¹⁹⁸	—	Tax Free ¹⁹⁶		Tax Free ¹⁹⁶
Netherlands	Tax Free	Tax Free	Tax Free	Tax Free	Fully Taxed ¹⁹⁷	—		—

¹⁹⁶ Because of unilateral relief provisions.¹⁹⁷ The foreign tax is only deductible from income in arriving at the tax base.

TABLE III O

Domicile of the Distributing Subsidiary

Domicile of the Distributee Subsidiary

Dividends from

↓

Dividends from	Belgium	France	Germany	Italy	Luxembourg	Netherlands
Belgium (Domicile of Distributee)	30% nil	30% nil ¹⁹⁸	30% tax credit	30% net amt. is subject to ex- cess profit tax	30% reduction by ⅔ths	30% nil
France (Domicile of Distributee)	24% nil	24% nil ¹⁹⁸	15% nil *	24% net amt. is subject to ex- cess profit tax	24% credit of 15% balance ded. from income	nil nil
Germany (Domicile of Distributee)	25% 12%	25% nil *	nil nil or ¹⁹⁹ 36%	25% net amt. is subject to ex- cess profit tax	25% partly exempt ²⁰⁰	25% nil
Italy (Domicile of Distributee)	nil 12%	nil nil ** ¹⁹⁸	nil taxed	nil taxed	nil taxed	nil nil
Luxembourg (Domicile of Distributee)	15% 12%	15% nil ¹⁹⁸	10% nil	15% net amt. is subject to ex- cess profit tax	nil nil	15% nil
Netherlands (Domicile of Distributee)	15% 12%	nil nil ¹⁹⁸	10% nil	nil *** net amt. is subject to ex- cess profit tax	15% net amt. taxed	nil nil

See footnotes on facing page.

inally imposed on the distributing subsidiary by its own domicile. Appraisal of the practical significance of the figures in the above chart would require, illustratively, that account be taken of the fact that Belgium and Germany would have assessed relatively low direct taxes against the distributing subsidiary itself, if domiciled there. And in all circumstances, it must be remembered that the recipient's tax base—the dividend—will be in an amount less than the distributing subsidiary's original taxable income even if the latter company distributed all of its available profit. That portion of its taxable income used to discharge its own tax liability to its domicile would not, of course, be available for distribution.

(c) *Further foreign turnover tax implications.*—In keeping with the principles discussed in Section D, *supra*, an export transaction from subsidiary No. 1 in country A to its own subsidiary in country B will be free of the export country's turnover tax. Also as indicated in that Section, the export subsidiary can obtain restitution of turnover taxes previously paid the export country at earlier stages of the product's development, this restitution being more or less complete except in Belgium and Luxembourg. While only the

* According to a new treaty.

Symbols: ** According to an old treaty.

*** According to a new treaty, otherwise 15%.

¹⁰⁸ As is indicated in the next paragraph, the regular corporate income tax imposed by France will have little impact when a French parent company receives a dividend. However, it is true that the French withholding tax of 24% must be paid when the dividend is received, though at a reduced rate of 12% when received from Belgium and, when received from Luxembourg, less a credit for the Luxembourg withholding tax. But upon immediate distribution by the French parent company to its own stockholders, the withholding tax will not again be assessed. The stockholders are even granted a credit of the full 24% against the general income tax on their total incomes (including the dividend in question). Since other countries, in the absence of a tax treaty, would impose a withholding tax on this second event (see Section B, *supra*), i.e., when the parent distributes the dividend, an overall comparison would lead to the conclusion that the French withholding tax should be disregarded or treated, at least, as a prepayment of the kind of tax due elsewhere when the parent distributes a dividend.

As stated above, the regular French corporate income tax will have little effect when the parent company first received the dividend. It will be levied on only 25% of the dividends received by the parent. This tax is designed to take into account the fact that a certain amount of the parent's overhead costs, though deducted by it from its profits, actually related to a dividend which was not, in principle, otherwise taxable.

¹⁰⁹ The 36% will apply if the parent company does not immediately distribute the amount as a dividend to its own shareholders.

²⁰⁰ Treaty provisions between the two countries limit Luxembourg as follows: For purposes of the Luxembourg corporate income tax, only the net amount received by the Luxembourg corporation from the German subsidiary may be taken into account, i.e., the 75% which remains after the German withholding tax is applied. Only 50% of that *net* is then subject to the Luxembourg corporate income tax. However, the full *net* is subject to the Luxembourg business or enterprise tax.

importing country's turnover tax is generally encountered under the foregoing arrangement, the chance of multiplying that tax is greater in this circumstance than when shipments are made from country A direct to independent customers in country B. The import or first taxable transaction will be followed by a second event, i.e., delivery by the receiving permanent establishment or subsidiary to its customers; in principle, that inland delivery will usually be treated as a second taxable event.

One might suppose that the rate applied to that second transaction would quite generally vary depending, *inter alia*, on whether the operation in country B was handled by a permanent establishment or a subsidiary. Assume, e.g., that the first subsidiary in country A had manufactured the product, shipping it to its sales office, a permanent establishment in country B. Since a *permanent establishment* is an extension of the manufacturing company in country A, delivery by the sales office to its own customers would be subjected in some countries to the rate applicable to manufacturers. A sales *subsidiary* in country B would usually be treated, however, as an independent entity for turnover tax purposes as well as other legal purposes. In other words, the rate applicable to wholesalers would usually be applied to its delivery, assuming this was not to the ultimate consumer. The two patterns just outlined have not always been adhered to, however, by Common Market countries.

Germany has frequently denied independent status to sales subsidiaries for the purpose of determining turnover tax rates, and in this circumstance has frequently applied the normal 4% manufacturer's rate, rather than the 1% wholesaler's rate, to the sales subsidiary's deliveries.

The Netherlands has followed the opposite tack; delivery by a sales office, whether a permanent establishment or a subsidiary, is deemed to have been made by a "dealer" subject to the $\frac{3}{4}$ % rate, assuming the sale is not to the ultimate consumer in which case delivery is free of tax. This result stems from the fact that the first import transaction was deemed equal to a manufacturer's sale within the Netherlands.

Italy and Belgium do not normally impose different rates on manufacturers and wholesalers. Accordingly, the problem noted above is not significant in that locale.

(d) *Conclusion: Choosing locale of foreign parent subsidiary, as affected by foreign tax considerations.*—Comparison of the tax costs associated with the selection of a locale for a foreign subsidiary which is to create its own permanent establishment or sub-

subsidiary in another member nation will be much less complex if the two will not be engaging in business transactions, such as exports, with each other. If in that circumstance, a permanent establishment is to be created in the second member nation, one need only integrate the effect of that nation's *direct* taxes with the *direct* taxes, if any, of the foreign subsidiary's domicile. If the latter of these two tax problems could be viewed in isolation, the ideal solution would be found in a fiscally neutral country, i.e., one which would not impose any direct tax on profits earned by a permanent establishment maintained elsewhere. From the chart in subtopic (a), *supra*, it appears, because of bilateral treaties or unilateral provisions, that France, Italy, and the Netherlands could provide such a neutral forum, with Belgium and Germany providing somewhat less attractive settings. It would be a mistake, however, to view the tax position of the controlling subsidiary's domicile in isolation. Indeed, when the tax costs of the two countries are integrated, a *non-neutral* country may actually furnish a more attractive domicile for the controlling subsidiary. Illustrative is the case where the controlling subsidiary's own earned income makes up the great preponderance of the total income earned by the two. In that circumstance, the fact that a country's tax on income earned domestically is lower than elsewhere may be more important in choosing the domicile for the controlling subsidiary than the fact that the country does impose some tax on income earned by a permanent establishment maintained elsewhere. This principle is illustrated in Table III P by comparing the total direct tax costs if non-neutral Belgium, rather than neutral Netherlands, were chosen as the site for a subsidiary which will earn \$500,000 from its own activities, its permanent establishment in country X earning only \$50,000.

The charted comparison indicates in the foregoing circumstance that, if all other things were equal, Belgium would provide a much more advantageous site for the controlling subsidiary. Table III Q illustrates that a different result can be reached, however, if one assumes the opposite facts, i.e., that the income earned by country X's permanent establishment (say, \$450,000) will far exceed that earned by the controlling subsidiary (assume \$100,000) from its own activities.

The two tables indicate that while Belgium was preferred as the site for the controlling subsidiary in the first assumed situation, the Netherlands would be preferred in the second, if all other things were equal. The fact that there are varying degrees in between the two situations suggests that *absolute* comparisons cannot actually

TABLE III P

· Earned Income of Country X's Permanent Estab.	Country X's Assumed Rate	Country X's Tax	Parent Subsidiary's Earned Income	Netherlands' Rate	Netherlands' Tax	Belgian Rate	Belgian Tax	Total Tax Load	
								Parent Sub- sidiary in Netherlands	Parent Sub- sidiary in Belgium
Parent Subsidiary Domiciled in Neutral Netherlands									
\$50,000	50%	\$25,000	\$500,000	47%	\$235,000			\$25,000 235,000 <u>\$260,000</u>	
Parent Subsidiary Domiciled in Non-neutral Belgium									
\$50,000	50%	\$25,000	\$500,000			1/3 of 30% 30%	3,000 150,000		\$28,000 150,000 <u>\$178,000</u>

TABLE III Q

Earned Income of Country X's Permanent Estab.	Country X's Assumed Rate	Country X's Tax	Parent Subsidiary's Earned Income	Netherlands' Rate	Netherlands' Tax	Belgian Rate	Belgian Tax	Total Tax Load	
								Parent Sub- sidiary in Netherlands	Parent Sub- sidiary in Belgium
Parent Subsidiary Domiciled in Neutral Netherlands									
\$450,000	50%	\$225,000	\$100,000	47%	\$47,000			<div>\$225,000 47,000 \$272,000</div>	
Parent Subsidiary Domiciled in Non-neutral Belgium									
\$450,000	50%	\$225,000	\$100,000			<div>1/2 of 30% 30%</div>	<div>\$27,000 30,000</div>		<div>\$252,000 30,000 \$282,000</div>

be made; results will differ depending on the precise circumstances.

The same is true if the controlling subsidiary creates a *subsidiary* in country X instead of a permanent establishment. Effective comparisons can only be made on the basis of certain assumptions, like those noted above. Here, however, it may also be necessary to take account of an additional tax on dividends. With reference to this circumstance, the Netherlands is the only neutral country, as is indicated in the charted comparison in subtopic (b), *supra*.

It was assumed throughout the foregoing discussion that the two affiliates would not indulge in business transactions with each other, such as exports from the parent subsidiary to the organization which it created in country X. While the direct tax loads will remain the same if such exports are contemplated, bilateral tax treaties, or—in their absence—unilateral provisions, require that the prices charged for products or services coincide for tax purposes with those which would be associated with transactions entered into at arm's length by independent companies. Turnover taxes would also complicate the comparisons in this setting, in the manner described in sub-topic (c), *supra*.

SUBSECTION 2. INTEGRATING FOREIGN AND AMERICAN INCOME TAX IMPLICATIONS

(a) *Introductory note.*—The method of determining an American company's gross income will not be further affected by the question of whether its own *operating* subsidiary in one Common Market country creates a permanent establishment or a sub-subsidiary in a second member nation. The parent's gross will still be dependent upon dividend payments from its own subsidiary. And everything said in Section C, *supra*, and in PART IV, *infra*, with reference to this question would be applicable here. In terms of principles, the prime previously undiscussed complication created by the subsidiary's extension of facilities into a second member nation relates to the credit for foreign income taxes. Since this will be affected in different ways, depending on whether a branch or sub-subsidiary is created in the second Common Market country, the two arrangements will be discussed under separate sub-topics below.

While the succeeding Section F will then go on to compare the *principles* governing these two-tier foreign arrangements with those applicable to the American parent's own establishment of "sister" foreign facilities, it should be noted here that the former's

practical advantages are actually similar, though not identical on all counts, to those associated with the use of a *pure* foreign holding (or "base") company created to own operating facilities. Reference is made, therefore, to Section G, *infra*, for an analysis of those *practical* advantages, though in the setting of a foreign base company arrangement.

(b) *Credit for foreign taxes where foreign subsidiary creates own permanent establishment in a second member nation.*

—Where a foreign operating subsidiary creates its own permanent establishment (branch) in a yet different member nation, the *initial* computation of the credit for foreign income taxes is not affected. The provisions authorizing both direct and deemed-paid credits are addressed to the income, war profits, and excess profits taxes of "*any*"²⁰¹ foreign country, not, in our illustration, just to those taxes of the first member nation in which the American parent's own subsidiary was incorporated. Illustratively, when the parent receives a dividend from the subsidiary, the deemed-paid credit allowed by § 902 would be computed in the first instance by multiplying the *aggregate* foreign income taxes of the subsidiary by the traditional fraction, the dividend being the numerator, and the pre-tax²⁰² accumulated profits being the denominator.

The literal language of the per-country limitation in § 904²⁰³ is not so easily applied. That provision expressly limits the *total* credit for taxes paid "*any country*" by a fraction, the numerator generally being the "*taxpayer's* taxable income from sources within *such country*," with the denominator being the taxpayer's entire taxable income.²⁰⁴ Of what significance is it that the subsidiary in our illustration would pay income taxes to more than one foreign country, while the American parent would actually derive foreign "*taxable income*" (a dividend) from only *one such country*? Admittedly, it was originally contemplated that the per-country limitation would generally be applied on a country-by-country basis. But it is equally true that the deemed-paid credit provision itself generally contemplated that an American parent would enjoy some credit with respect to the foreign income taxes paid by a foreign subsidiary to "*any foreign country*."²⁰⁵ In resolving the interpretative difficulty posed by the statutory language used in connection

²⁰¹ I.R.C., §§ 901(b)(1) and 902(a).

²⁰² The term "*pre-tax* accumulated profits" is used here to mean accumulated profits after deducting all direct taxes except those types which qualify for the credit.

²⁰³ Discussed generally in Subsection 1(f) of Section C, *supra*.

²⁰⁴ The numerator cannot exceed the taxpayer's "entire taxable income."

²⁰⁵ I.R.C., § 902(a).

with the per-country limitation, the Treasury has neutralized any prejudice which the parent otherwise might have suffered as a result of the fact that the dividend had its source in but one country, that in which the subsidiary was incorporated. To that same country, the Treasury has attributed *all* of the income, war profits, and excess profits taxes paid or deemed to have been paid by that subsidiary even though such taxes may have been imposed by and paid to two or more different foreign countries.²⁰⁸ In effect, this permits an averaging of the foreign tax loads imposed by two or more foreign countries, thus permitting some escape from the per-country limitation in that instance where one of the foreign countries had a higher, and the other had a lower, effective rate than the United States. The result is similar to that which would follow if an overall limitation, rather than per-country limitation, were applied to the credit.^{208a}

(c) *Foreign operating subsidiary creates own subsidiary in a second member nation.*—Until World War II, the *deemed-paid* credit allowed an American corporation was confined to the foreign income taxes of its own foreign subsidiary; neither were “deemed,” for purposes of the American credit, to have paid the foreign income taxes of a *second tier* foreign subsidiary, the stock of which was held by the first subsidiary. At that time, at least for deemed-paid credit purposes, it made greater sense if the parent’s own foreign subsidiary created a permanent establishment instead of a subsidiary in the second European country. Or the latter’s income taxes could also have been brought within the sweep of the deemed-paid credit provision if the parent *itself* created a second “sister” subsidiary there.

For a variety of reasons, a parent organization often preferred to handle its affairs in the second country through an entity incorporated there. But only if the latter was an unincorporated branch of the parent’s first subsidiary was it easy to satisfy *both* of two succeeding tax aims: (1) to use the first facility’s profits to develop and expand the second facility without having to route those profits through the American parent’s gross income; and (2) in a later distribution stage, to enjoy a deemed-paid credit for the income

²⁰⁸ I.T. Regs., § 1.902-1(c).

^{208a} By virtue of legislation enacted in late 1960, the American parent could reach the same result by electing to submit its foreign tax credit to the newly revived “overall” limitation. Its ramifications, and the differences which may arise between it and the per-country limitation in a multiple-tier setting, are discussed in Sections F and G *infra*.

taxes of the second European country. Only the second of these could be achieved if the parent itself formed the second subsidiary, absent some sort of loan arrangement between the two subsidiaries.

In the middle of World War II, Congress resolved an American corporation's planning problem by extending the "deemed-paid" concept. It provided that a foreign subsidiary, upon receipt of a dividend from its own foreign incorporated subsidiary, "shall be deemed to have paid" a portion of the latter's income tax, the fraction to be of the same type as that previously used in connection with the parent's previously existing deemed-paid credit for the first subsidiary's tax.²⁰⁷

When initially enacted, the first subsidiary was deemed to have paid a fractional part of the second subsidiary's tax only if the former owned "*all* the voting stock (except qualifying shares)" in the second subsidiary.²⁰⁸ However, in 1950—in connection with the tax hearings designed to give further impetus to the Point 4 Program, Congress was urged by business to relax this requirement.²⁰⁹ The consequent reduction coincided with a downgrading in the proportion of ownership which the parent had to hold in the first subsidiary in order to be deemed to have paid a fractional part of its income taxes. A reduction to 10% in the latter situation²¹⁰ was complemented by changing the word "*all*" to "*50%*" with reference to the voting stock which one foreign corporation had to hold in the sub-subsidiary.²¹¹ Indeed, these limitations were assertedly retained only because of certain "administrative" problems.²¹²

Under the two deemed-paid arrangements, if the profits of *both* subsidiaries suffered the same amount of foreign tax, and if *both* distributed *all* of their *after-tax* profits, American gross income and the parent's deemed-paid credit would be equal to what they would have been if the first subsidiary had earned the entire foreign profit. Assume for example that each earned \$100,000 on which

²⁰⁷ Rev. Act of 1942, § 131(f) (2), now as revised, I.R.C., § 902(b).

²⁰⁸ Rev. Act of 1942, § 131(f) (2).

²⁰⁹ For example, see statement of Mitchell B. Carroll, Hearings, Committee on Ways and Means, 81st Cong., 2d Sess. (1950) Vol. 3, 623 at 626.

²¹⁰ Rev. Act of 1951, § 332(a), now I.R.C., § 902(a).

²¹¹ Rev. Act of 1951, § 332(b), now I.R.C., § 902(b).

²¹² S. Rep. No. 781, 82d Cong., 1st Sess. 55 (1951). These administrative difficulties did not appear quite so formidable to a later inquiring House committee. In 1960 the Committee on Ways and Means proposed, and the House agreed, to reduce the 50% requirement as it related to a sub-subsidiary to 20%, the sponsoring Committee stating that this would "provide fully for any administrative problems." H. Rep. No. 2100, 86th Cong., 2d Sess. 3 (1960) re H.R. 11,681. When the session closed, the Senate had not reached consideration of this bill.

a foreign tax of 26% (\$26,000 by each) was suffered. The first subsidiary would be "deemed to have paid" \$19,240 of its own subsidiary's foreign tax, computed as follows:

$$\$26,000 \times \frac{\$74,000 \text{ (Dividend)}}{\$100,000 \text{ (Pre-tax Profit)}} = \$19,240$$

The first subsidiary's total foreign tax would now be \$45,240 (own tax of \$26,000 plus deemed-paid tax of \$19,240) for which the American parent would get a deemed-paid credit of \$38,480, computed as follows:

$$\$45,240 \times \frac{\$148,000 \text{ (Dividend To Parent)}}{\$174,000 \text{ (First Subsidiary's Own Pre-tax Profit)}} = \$38,480^{213}$$

If the first subsidiary had earned the entire profit of \$200,000, suffering a 26% tax (\$52,000), the parent's deemed-paid credit would be computed as follows:

$$\$52,000 \times \frac{\$148,000 \text{ (Dividend)}}{\$200,000 \text{ (Subsidiary's Pre-tax Profit)}} = \$38,480$$

The one-tier and two-tier deemed-paid arrangements will not give rise to like results, however, if there is a variation in the amount of tax suffered by the two facilities. In such case, the American parent could actually enjoy a slightly greater ultimate tax advantage from the sub-subsidiary or two-tier deemed-paid arrangement than from the older single subsidiary or one-tier deemed-paid arrangement. The reason is the same as that which was responsible for the ultimate tax advantage which a subsidiary arrangement enjoyed over a branch operation even in that case where all after-tax profits are remitted.²¹⁴ In a period when the subsidiary and sub-subsidiary distribute all of their respective after-tax profits, that portion of the sub-subsidiary's profits devoted to its own income tax never becomes gross income to the first subsidiary. Though this exclusion is economically equivalent to a deduction for that tax, the first subsidiary will still be deemed to have paid a part of that tax for credit purposes.

Even if an American enterprise intended only to have *one* subsidiary which in turn would have but one subsidiary of its own,

²¹³ A somewhat similar example is contained in H. Rep. No. 2333, 77th Cong., 2d Sess. 101 (1942).

²¹⁴ See discussion in Section C, *supra*.

the range of possible tax patterns and rate relationships in the Common Market is so varied as to preclude, at least in this type of study, any really meaningful comparison of the integrated American and foreign direct tax costs with respect to all of the location possibilities. With only the simple two-tier organizational structure described above, there would be 36 location possibilities within the Common Market. Comparisons, to be meaningful in the sense of being generally applicable, would have to go on to accommodate the infinite variety in relative sizes of the two facilities. And to the variety of rate structures which could be applied directly on *operating* profits, one would have to add the variation in rate patterns which might be applied to the inter-corporate dividends—in terms of the withholding taxes imposed by the sub-subsidiary's domicile as well as any tax which might be imposed by the distributee's own domicile at the time it received the dividend and again when the net was re-distributed to the American parent. On this one count, for example, only if the sub-subsidiary is incorporated in Italy, and the parent's own subsidiary is in the Netherlands, will there be no tax on dividends as such, except that imposed by the United States when the parent ultimately receives a distribution. But even in this setting, as in certain others, the fact that some Italian direct taxes would not seem to qualify for the credit further complicates the matter.

With reference to this general arrangement, however, it should be noted that—as in the case where the first subsidiary created a permanent establishment in the second member nation—those qualifying taxes of the sub-subsidiary deemed paid by the parent's own subsidiary will be treated, for purposes of the per-country limitation, as though imposed on the latter by its own country of incorporation.²¹⁵ Here too, then, an averaging of the foreign tax loads is in effect substituted for the per-country approach in determining the limitation on the credit for foreign taxes.

SECTION F. TAX IMPLICATIONS IF AN AMERICAN ENTERPRISE CREATES "SISTER" FOREIGN PERMANENT ESTABLISHMENTS OR FOREIGN SUBSIDIARIES

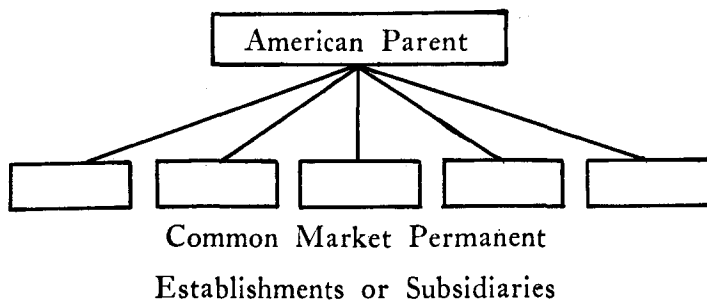
(a) *Introductory note.*—The discussion in Section D, *supra*, indicated that double taxation within the Common Market itself would almost never arise in that instance where an American enterprise's Common Market subsidiary exported directly to customers in other member nations. Business reasons, however,

²¹⁵ I.T. Regs., § 1.902-1(c).

might make it desirable to have some sort of facility in the second member nation. Accordingly, the immediately preceding Section E considered the tax implications where the first operating subsidiary created its own permanent establishments (branches) or subsidiaries in one or more of the other member nations. That same Section indicated, however, that double taxation *within* the Common Market itself would be one cost associated with a few choices of locale in that instance where the Common Market subsidiary created its own permanent establishment in another member nation. That same result would follow in a few more instances if the first Common Market subsidiary created a subsidiary in the second member nation instead of creating a permanent establishment. Because certain choices of locale in these last two instances would involve double taxation within the Common Market itself, the total European direct tax load might exceed the American rate on dividends eventually received by the American parent. In that event, the unilateral relief provisions (a credit) in the Internal Revenue Code would be inadequate to avoid further double taxation.

Other difficulties may also be associated with the tier or chain arrangement. As is more fully explained in the discussion of base company operations in Section G, *infra*, the American parent might encounter some difficulty in availing itself of the special credit provision with respect to any royalties received from sub-subsidiaries. Also, as is more fully explained there, if the first operating subsidiary created permanent establishments in the other member nations, losses, if any, incurred by the latter would prejudice the opportunity to take a *full* credit for income taxes paid in those countries where the operations were profitable.

For the foregoing reasons, consideration might be given to a different type of organization, as follows:



(b) *Foreign direct taxes re "sister" facilities created by an American parent.*—The charted arrangement above, involving creation by the American enterprise itself of "sister" foreign permanent establishments or subsidiaries, would completely avoid double taxation *within* the Common Market itself. The foreign direct tax implications would be identical to those discussed *supra*, in Section B.

If the American enterprise also contemplates direct exports to customers in those same member nations, an appropriate part of the export profit will generally be attributed to the permanent establishment located in the importing country. Sub-topic (b) of the preceding Section B compares the differences in tax loads which would be imposed by the various member nations in this circumstance. This same problem will arise if Common Market subsidiaries are used to represent the American enterprise in member nations, for in fact such a representative will usually constitute a permanent establishment. In this connection, see the discussions in PART II and in Section B of this PART III.

(c) *American tax implications: In general.*—Subject to one basic exception which arises only if a domestic parent so elects, the *American* tax implications associated with creation by a domestic parent of "sister" permanent establishments or subsidiaries in different Common Market countries would be governed by the principles described in the preceding Section C where discussion actually centered on creation of but one foreign facility designed only to serve one member nation. Illustratively, as distinguished from the chain arrangement discussed in the immediately preceding Section F, the profits of sister facilities in different countries would be isolated, one from the other, in applying the per-country limitation on the credit.²¹⁶ Losses incurred by a branch in one country would not prejudice allowance of a full credit for foreign income taxes paid by a profitable branch in another country.²¹⁷

Another advantage, where sister subsidiaries are established, involves the American parent's opportunity, without difficulty, to avail itself of the special credit allowed under certain circumstances for royalties received in lieu of dividends.^{217a}

Tax-wise, the two most general shortcomings of this arrangement involve, first, the fact that, absent some inter-subsidiary loan ar-

²¹⁶ I.R.C., § 904, discussed more fully in Section C, Subsection 1, *supra*.

²¹⁷ Discussed more fully in the succeeding Section G.

^{217a} *Id.*

rangement, profits of one subsidiary could not be used to expand another without routing that profit through the American parent's income ledger. If branches are used, this would not be an *additional* difficulty, however; their respective incomes would be includible by the American parent whether or not remitted. The second disadvantage grows out of the application of the per-country limitation on the credit; that limitation would prevent averaging for the purpose of leveling out the different high- and low-tax countries, such as Germany and Belgium. However, by virtue of new legislation enacted in late 1960, this result can be avoided if the taxpayer chooses, by election, to substitute an "overall" limitation for the per-country limitation, as is more fully discussed in the immediately succeeding sub-topic.

(d) *American tax implications: The alternative "overall" limitation.*—Congress has not "hewn a straight path" with reference to the kind of limitation which should be applied to the credit for foreign taxes. The story^{217b} goes back to 1918 when, for a period of three years, a corporation's affairs were viewed on a *world-wide* basis, the credit then being so designed that foreign taxes imposed at rates exceeding those prevailing in the United States could reduce American tax liability on *domestic* income. In terms of net effect, a world-wide average rate was actually applied. Then for eleven years, from 1921 to 1932, corporate affairs were divided into two parts, domestic and foreign, with an "overall" limitation on the credit serving to prevent *total* foreign taxes, *wherever paid*, from reducing the American tax on domestic income.^{217c} The net effect, with respect to the limitation, was to permit a taxpayer to average out the high and low foreign income taxes, a disadvantage, generally speaking, only where losses were encountered in one of the foreign countries. Then for the succeeding twenty-two years, 1932 to 1954, two different *sets* of divisions were applied to a corporation's affairs; its activities were first divided into two parts, domestic and foreign, to the same end as that noted above. Then they were re-divided on a *per-country* basis, the aim being to prevent the taxes of one country which might have a higher effective rate than the United States from being averaged with the rates of a low-tax country in determining the limit on the credit for foreign taxes paid the high-tax country.^{217d} Only this latter per-

^{217b} Discussed more fully in Section C, Subsection 1(f), *supra*.

^{217c} Rev. Act of 1921, § 238(a).

^{217d} Rev. Act of 1932, § 131(b).

country limitation survived the comprehensive revision of the Code in 1954, the overall limitation being eliminated.^{217e} The asserted reason related to the disadvantage which some taxpayers suffered as a result of the *overall* limitation, i.e., to the previously mentioned fact that losses incurred in one foreign country were averaged with profits in another country, thus increasing the chance of a reduction in the American credit for taxes actually paid the foreign country where profits had been reaped. Congress concluded that this tended to discourage companies from using their foreign profits to open new businesses in countries in which they had not previously carried on business.^{217f}

During the period when only the per-country limitation was in vogue (1954 to 1960), it was still possible, as noted in Subsection 2 of the preceding Section E, for an enterprise to organize its affairs so as to avoid the strict impact of the country-by-country approach. As noted there, where the American parent had its first foreign *operating* subsidiary create its own permanent establishments or sub-subsidiaries in other countries, for purposes of the per-country limitation, the American parent's entire income from the multi-country foreign operation (dividends) was deemed to have been derived from the country in which the first tier foreign subsidiary was incorporated, thus permitting what was in effect an averaging of high- and low-tax countries. The immediately succeeding Section G indicates that a like result was reached where ownership of the foreign permanent establishments or subsidiaries was consolidated under one foreign *holding* company.

In 1960, Congress re-examined the "limitations" question. Embarrassing any mutually exclusive congressional choice between the two methods ("per-country" and "overall") was the fact, as noted above, that for years taxpayers had enjoyed what was tantamount to an election between the two limitations; organizational form, not substance, made the difference.

In late 1960, the appropriate House and Senate committees agreed to resolve the problem by writing an election into the law itself, giving corporations a choice to conform either to the per-country or to an overall limitation. Those which had already been subject to the per-country limitation were given the unrestricted right to shift, at their own election.^{217g} While the Treasury Depart-

^{217e} I.R.C., § 904.

^{217f} S. Rep. No. 1622, 83d Cong., 2d Sess. 106 (1954).

^{217g} Pub. Law 86-780, 86th Cong., 2d Sess. (1960) § 1, amending I.R.C., § 904.

ment had objected earlier to a somewhat similar proposal—primarily because of the revenue loss involved,^{217h} it indicated a willingness to accept the Senate's variation on the House committee's proposal.²¹⁷ⁱ Whereas the House would have permitted a corporation to shift from one limitation to the other every five years, the Senate would permit a company which invoked the overall limitation to shift to the per-country limitation, or later again shift back to the overall limitation, only with the consent of the Treasury.^{217j} While the Senate's restrictions were written into the law as enacted,^{217k} the damaging thrust—from a taxpayer's viewpoint—will probably be cushioned because of the Senate committee's expressed view that such consent should be granted by the Treasury whenever there are basic changes in the taxpayer's business, such as where taxpayers are "about to enter substantial operations in a new foreign country and anticipate that the operations in that country will prove risky with the possibility of their resulting in a loss for a number of years,"^{217l} in which case the taxpayer who previously had invoked the overall limitation might now want to shift to the per-country limitation. It was also contemplated that the shift back to the per-country limitation would be permitted where "substantial losses are realized with respect to existing investments because of nationalization, expropriation, or war."^{217m}

Assuming administrative compliance with the Senate committee's views as to when a further shift will be permitted after the taxpayer has once elected to come under the overall limitation, such shifts, assuming satisfaction of those standards, can presumably be accomplished on the basis of "hindsight." More specifically, assuming Treasury consent can be obtained because there has been the type of operational change contemplated by the Senate committee, the shift from or back to the overall limitation may be made with respect to any taxable year for which the statute of limitations has not yet run on refund rights.²¹⁷ⁿ

This possibility of resorting to hindsight, i.e., making an election retroactive where the standard requisite to further change was actually met in an earlier year, may cushion in at least one circum-

^{217h} Letter from the Secretary of the Treasury to the Chairman of the House Committee on Ways and Means, May 6, 1959, in '59 Vol. 6 CCH para. 6469.

²¹⁷ⁱ S. Rep. No. 1393, 86th Cong., 2d Sess. 3 (1960).

^{217j} *Id.*, at 2.

^{217k} Note 217g, *supra*, subsection 1(b).

^{217l} Note 217i, *supra*, 5.

^{217m} *Id.*

²¹⁷ⁿ Note 217g, *supra*, subsection 1(b).

stance another generally applicable and quite significant restriction. While the House committee would have permitted excess unused credits of a per-country-limitation year to be carried forward or back into an overall-limitation year as well as into a per-country year, though not *vice versa*,^{217o} the Senate^{217p} and ultimately the Congress decided not to permit any such commingling between the two different types of years.^{217q} Where, at the time a basic change in operations occurs, it is not clear that a further shift to a different limitation should be invoked, it will be at least theoretically possible to change later, *on a retroactive* basis but within the refund period, if as events turn out the taxpayer's old limitation resulted in unused excess credits which could have been accommodated had the other limitation been in force.

Finally, the new bill would deny averaging under the overall limitation to the extent foreign taxes are above those of the United States because of the fourteen-percentage-point tax differential allowed Western Hemisphere Trade Corporations.^{217r} In short, it was not thought that the excess foreign tax on the latter type of corporation should be allowed to wipe out U.S. taxes imposed at the *regular* corporate rate on income earned in countries where the foreign taxes involved are less than those imposed by the United States.^{217s}

It was previously noted that even before enactment of the new statutory election, taxpayers had enjoyed what was tantamount to an election between the two types of limitation because of their right to choose the organizational form in which foreign operations would be housed. Whereas averaging, of the type associated with the overall limitation, resulted if one foreign subsidiary created its own diverse branches (permanent establishments), the strict country-by-country approach applied if the American parent itself created sister foreign branches or subsidiaries. There are certain significant practical differences, as well as similarities, between what was formerly, and remains today, only tantamount to an election, and the new specific statutory election.

First, where business reasons forced a choice of organizational form which itself led to averaging, as in the first of the two types

^{217o} H. Rep. No. 1358, 86th Cong., 2d Sess. 5 (1960).

^{217p} S. Rep. No. 1393, 86th Cong., 2d Sess. 3 (1960).

^{217q} Pub. Law 86-780, 86th Cong., 2d Sess. (1960), § 1(d), adding subsections 904(e) and (f) to the Code.

^{217r} *Id.*, § 2, amending I.R.C., § 1503.

^{217s} S. Rep. No. 1393, 86th Cong., 2d Sess. 6 (1960).

of cases mentioned *supra*, that organizational form did not and will not have the opportunity to invoke a strict country-by-country approach to the limitation. The reason: averaging or an overall approach results from the way the *per-country* limitation itself is interpreted in that setting. On the other hand, under the new legislation, foreign operations involving sister subsidiaries created by the American parent itself enjoy a real option between a strict country-by-country approach and an overall approach.

Second, if it be assumed in the two foregoing situations that both domestic parents had computed the limitation by reference to an averaging technique, one because of organizational form, the other having previously invoked the overall limitation by an election, both could still isolate a new substantial operation to be initiated in a yet different foreign country if there is concern over the prospect that losses there incurred would reduce the credit for foreign taxes paid other countries in which profitable businesses had been carried on. The American parent which had established sister foreign facilities would simply establish another sister facility, simultaneously revoking its election to conform to the overall limitation.^{217t} The other American parent would have to deviate from its own organizational practice in isolating the new facility; the parent itself, rather than its top tier foreign subsidiary, would have to create the new facility. The per-country limitation, having previously applied to the parent's older chain arrangement though there having an averaging effect, would now serve to isolate the losses of the new facility.

Third, implicit in the solution of the immediately preceding problem is a yet more sweeping difference between that averaging which is accomplished by organizational form under the per-country limitation and that which would be accomplished through invocation of the new statutory election. The statutory election to invoke the overall limitation affects a company's *total* or world-wide foreign operations, subject only to the previously noted restriction regarding Western Hemisphere Corporations. Averaging accomplished, on the other hand, solely by reference to the impact of organizational form on the per-country limitation can be applied on a selective basis, in two different respects. The first is illustrated by a previously mentioned example, i.e., by a case where a chain organization is used in covering certain foreign countries, averaging being the goal,

^{217t} It is assumed here that the standard requisite to securing the Treasury's consent can be met by reference to the Senate committee's expressed views regarding the contemplated shape of those standards.

with the American parent itself creating sister facilities in all other countries where a strict country-by-country approach is desired. The second type of selectivity is illustrated by the case where two or more top tier subsidiaries, each with its own satellites, are created by the parent on the same foreign continent but in different countries, or on different continents. While the per-country limitation would require averaging of foreign taxes within each chain, the two chains would be dealt with separately under that limitation.

A final major difference between that averaging which is accomplished under the per-country limitation by reference to organizational form and that which could be accomplished through the statutory election involves the opportunity, though only in the latter case, to resort to the type of hindsight described earlier.

SECTION G. TAX IMPLICATIONS RE USE OF FOREIGN HOLDING COMPANY HOLDING STOCK IN ONE OR MORE FOREIGN SUBSIDIARIES

(a) *Introduction.*—Various business reasons may make it desirable to control several foreign operating subsidiaries through a foreign holding company. Control may be more effectively exercised in this manner than through a domestic department of the American enterprise. Financial and commercial policies may be more easily integrated into those of the Common Market. Use of European banking facilities, including credit arrangements, may be facilitated. Such a holding company could also be used as a buffer to shield European profits from American taxation; profits made by a subsidiary in one member nation could be deflected to an expanding subsidiary in another, without routing dividends through the American parent. The advantage of this practice can be measured by the degree to which the American tax rate exceeds the European tax load imposed on the operating facilities, provided the foreign holding company enjoys a favorable tax regime.

The tax laws of five Common Market countries do not distinguish between a "pure" holding company and an operating company which also holds shares in other operating companies. Luxembourg, however, has established a most favorable tax climate for pure holding companies. Of the others, the Netherlands provides the most attractive setting for a holding company arrangement. The tax position of other member nations and of so-called tax havens outside the Common Market will be discussed after

consideration of the tax implications associated with use of Luxembourg and the Netherlands as sites for the holding company.

(b) *Luxembourg as a domicile for the holding company.*—For all practical purposes, a pure Luxembourg holding company, having a paid-in capital of less than \$20,000,000 (L. Fr. 1,000,000,000), is exempt from income as well as property taxes. Moreover, dividends and interest which it pays out are also exempt from the tax on movable capital even where payment is made to a nonresident.

The one significant exception to the foregoing involves the situation where the Luxembourg holding company holds shares in a local Luxembourg operating subsidiary. Dividends paid by the latter will be subjected to the normal withholding tax on movable capital.

In the end, Luxembourg holding companies of the type first described will pay only three taxes, all of which are related to the capital structure:

(1) *Droit d'apport* is imposed on the payment of capital into the corporation, the rate being .32%. This tax is also levied at the time the company is liquidated;

(2) *Droit de timbre* is imposed at the rate of .1% on the issuance of shares and debentures, measured by their values; and

(3) *Droit d'abonnement* is an annual tax on the capital of the holding company, the rate being .16%.

Another class of Luxembourg holding companies are those to which a foreign corporation has paid in capital of \$20,000,000 (L. Fr. 1,000,000,000) or more. These, known as *Société holding Milliardaire*, are free of the above described *Droit d'abonnement* as well as normal income and property taxes. They are subject, however, to the *Droit d'apport* at the time capital is paid in, and to the *Droit de timbre* on the issuance of shares and debentures, both being geared in this instance to a regressive rate schedule, as in Table III R.

TABLE III R

<i>Paid-in Capital</i>	<i>Droit d'apport</i>	<i>Value of Shares</i>	<i>Droit de timbre</i>	<i>Value of Debentures</i>	<i>Droit de timbre</i>
First \$20,000,000	.32%	First \$20,000,000	.1%	First \$60,000,000	.1%
Next \$20,000,000	.24%	Next \$20,000,000	.08%	Next \$20,000,000	.08%
Next \$20,000,000	.12%	Next \$20,000,000	.04%	Next \$20,000,000	.025%
Next \$20,000,000	.06%	Next \$20,000,000	.02%	Balance	.02%
Next \$20,000,000	.01%	Balance	.005%		
Balance	.015%				

From Table III R, it appears that the total tax at the time capital is paid in, and shares or debentures are issued, will run at least to \$84,000, assuming a minimum \$20,000,000 is paid in. Apart from the *Droit de timbre*, a special annual tax is levied on this second class of larger holding companies, covering interest paid on debentures issued by the holding company, dividends paid out on its stock, and salaries or other remuneration paid directors and managers who do not stay in Luxembourg at least 6 months out of the year. Interest paid out on debentures is taxed at a uniform rate of 3%. The rate on dividends and the type of remuneration described above falls, however, into two classes, each class being determined by reference to the amount of *interest* paid out, as in Table III S.

TABLE III S

<i>Amount of Interest Paid on Debentures</i>	<i>Amount of Dividends and Special Class of Remuneration</i>	<i>Rate on Dividends and Remuneration</i>
<i>Class I</i> \$2,000,000 or less	a. First \$1,000,000 or less b. Excess over \$1,000,000	.18% .1 %
<i>Class II</i> Over \$2,000,000	a. To the extent the amount is less than the amount by which interest payments exceed \$2,000,000 b. Next \$1,000,000 c. Balance	3.0 % .18% .1 %

The minimum amount assessed under this special tax is \$32,000 (L. Fr. 1,600,000) per year.

In analyzing the amount which could be subjected to the foregoing taxes, it must be remembered that the holding company will not always receive the *gross* amount of dividends declared by the operating facilities, for certain Common Market countries will have imposed a withholding tax on dividends declared by operating facilities domiciled there, as follows:

<i>Country</i>	<i>Tax</i>
Belgium	Taxe Mobilière, 30%
France	Withholding tax, 24%
Germany	Tax on income from movable capital, 25%
Italy	No dividend tax
Netherlands	Dividend tax, 15%

(c) Netherlands as a domicile for the holding company.—

The Netherlands does not confine its favorable tax climate to "pure" holding companies. Equally attractive benefits are available if an American enterprise chooses to have its operating subsidiary in the Netherlands hold the shares in other European operating companies.

Dividends received by a Netherlands corporation from foreign companies are exempt from the regular taxes which the Netherlands would otherwise impose if (1) the Netherlands corporation holds at least 25% of the foreign corporation's shares and (2) the foreign corporation itself was liable for a domiciliary income tax on its profits.

By treaty, the Netherlands has also abandoned the right to tax dividends which the Netherlands corporation would in turn pay the American parent corporation. Thus, apart from the registration fees and stamp duties which would be imposed on the formation of the Netherlands corporation (see PART I) dividends received by the Netherlands holding company and distributed to the American parent would have been subjected only to the withholding taxes imposed by certain Common Market countries at the time the operating subsidiaries distributed their profits, as follows:

<i>Country</i>	<i>Tax</i>
Belgium	Taxe Mobilière, 30%
France	No withholding tax (Treaty)
Italy	No dividend tax
Germany	Tax on income from movable capital, 25%
Luxembourg	Tax on income from movable capital, 15%
Netherlands	No dividend tax

*(d) Other Common Market countries as domiciles for the holding company.—*Common Market countries other than Luxembourg and the Netherlands do not offer special benefits for holding company arrangements. For example, dividends received by a German corporation are tax exempt only if received from a German subsidiary, and even then the receiving company will suffer a 36% tax if the amount received is not immediately distributed by it. Nor do France²¹⁸ and Belgium provide exemptions

²¹⁸ The French 24% withholding tax will apply upon receipt of the dividend, though upon re-distribution of that dividend by the holding company another withholding tax will not be applied. Upon the receipt of the dividend, the holding company is also allowed a 75% dividends-received deduction for purposes of the regular French corporate income tax. The 25% not neutralized is taxed as a means of compensating for that portion of overhead expenses which, though deducted by the parent, were properly attributable to the dividend.

for dividends received. However, when the holding company itself distributes profits derived from dividends, those two countries do not again exact their respective withholding tax, and *Taxe Mobilière*, in the instance where a subsidiary had been the source of the holding company's earnings.

Finally, on formation of a holding company, all Common Market countries except Luxembourg exact the regular registration fees and stamp duties imposed, as discussed in PART I, on formation of corporations generally. Luxembourg's special arrangements were considered in sub-topic (b), *supra*.

(e) *Incorporation of the holding company in a so-called "tax haven."*—The term, "tax haven," is usually applied to a country which does not exact any tax, or at most only a nominal amount, from holding companies. As previously indicated, Luxembourg is the only Common Market country which fits that classification, though the Netherlands also may be considered as such. Among non-member European nations, Switzerland and Liechtenstein are the most frequently mentioned tax havens.

Holding companies in Switzerland do not pay an income tax on dividends received. Since cantonal (state) tax laws are generally more burdensome than the Swiss federal income tax, it is also important to note that some cantonal laws also provide an exemption for interest and royalties received, as well as dividends received. On the other hand, federal, cantonal, and sometimes even local property taxes are imposed on a holding company's net wealth or paid-in capital. While the rates of these taxes rarely run as high as 1%, dividends paid out by the holding company to the American parent company will suffer a withholding tax of 5% provided the American parent owns at least 95% of the holding company's stock. Otherwise, the rate would be 15%.

Liechtenstein also frees dividends received from its income tax. While the holding company will suffer a .1% tax on its property, an agreement as to this can be made with the tax department covering a 30-year period. Finally, dividends paid by the holding company to the American parent will be subjected to a 3% coupon tax.

When account is taken of the 5% and 3% taxes which Switzerland and Liechtenstein would impose, respectively, on dividends paid by the holding company to the American parent, and of the property taxes which would be assessed in each of those countries, it should be apparent that they do not offer holding companies any

significant tax advantage superior to those available in certain Common Market countries. While the tax which those two countries would normally impose on dividends to the American parent would not be incurred if the holding company retained its profits for expansion purposes, such accumulation would serve to increase the company's property taxes. It should also be noted that the two countries in question do not have as many tax treaties with Common Market countries as the latter have among themselves. In some instances, this may further prejudice their selection, particularly a choice of Liechtenstein, as the domicile for the holding company. Common Market countries will assess the following withholding taxes on dividends paid by operating subsidiaries domiciled there to a holding company domiciled in one of those two countries as appears in Table III T.

TABLE III T

<i>Dividend Paid by Operating Subsidiary Located In:</i>	<i>Tax Assessed by Domicile of Operating Subsidiary on Dividends Payable to Holding Co. In</i>	
	Switzerland	Liechtenstein
Belgium	30%	30%
France	—	24%
Germany	25%	25%
Italy	—	—
Luxembourg	15%	15%
Netherlands	—	15%

Comparison of these figures with those set forth in sub-topics (b) and (c) as applied to Luxembourg and the Netherlands indicates that in some instances the latter two countries enjoy an advantage in this respect.

SUBSECTION 2. AMERICAN TAX IMPLICATIONS RE USE OF A FOREIGN BASE COMPANY

(a) *Introductory note.*—Following consideration of the American tax implications associated with a base company arrangement during the operational phase, certain problems peculiarly incident to the creation of such companies will be analyzed.

(b) *General tax implications.*—With respect to the normal operational stage, it is from two principles that the practical American tax advantages of the base company arrangement arise.

The first such principle is common to all foreign corporations, namely, that the income which the foreign base company derives from Common Market sources will not be included in American gross income²¹⁹ unless distributed as a dividend to the American parent. Thus, as indicated in the Introduction to this Section, where the effective American tax rate is higher than the *total* effective income tax rate imposed by the country which houses an operating facility, the latter facility's profit could be deflected through the base company to other expanding foreign facilities without suffering what may be an expensive tax detour through the American parent.

Fear that exchange controls will emerge in the operational country may actually be the only immediate reason for a current or timely extraction of profits made by the operating facility located there; these profits could be stored in a base company situated elsewhere until such time as they are needed for expansion of foreign facilities in yet other countries. Storing them in such a company in this circumstance, instead of remitting them to the United States, may also be motivated by a desire to avoid the risks associated with the American tax on unreasonable accumulations.²²⁰ As noted in PART I, generally speaking the Common Market countries have not resorted to this type of penalty tax.

The first principle, that a base company's income is not reachable by American authorities until distributed as a dividend to the American parent, also enables this type of organizational structure to accommodate, without American tax cost, dividend requirements of European interests which may own shares in the operational subsidiaries. The amount which otherwise would have been distributed as the American parent's share would be deflected to the foreign base company. Where outside interests are involved in this way, the base company type of organizational structure would not be so acceptable, however, if the outsiders owned more than 50% of the voting stock of one or more of the operating companies. As is explained more fully in Subsection 2(c) of Section E, *supra*, the American parent's eventual deemed-paid credit for foreign income taxes of an operating company will be lost unless the foreign base company, in which the American parent must hold at least

²¹⁹ I.R.C., § 882(b). This principle is discussed more fully in Section C, *supra*.

²²⁰ Since the foreign profit will not have become a part of American gross income, it would not be a part of the base to which the penalty tax attaches, i.e., "accumulated taxable income." I.R.C., § 531.

10% of the voting stock, in turn owns at least 50% of the voting stock of the sub-subsidiary.^{220a}

The second basic tax principle to which a base company arrangement's tax advantage is attributable involves another provision bearing on the credit. As was also explained more fully in Subsection 2 of Section E, *supra*, when profits derived by a holding company from two or more Common Market countries are ultimately remitted to the States, an averaging arrangement²²¹ is read into the per-country limitation²²² on the credit for foreign income taxes. Normally, this will be advantageous in the instance where one operating facility is situated in a low income tax country like Italy, another being in a country having a higher effective rate than the United States. By treating the foreign income as though derived from the one country in which the base company is incorporated, and by attributing to that single country the total foreign tax paid to the operational countries, there is less likelihood of prejudice from the per-country limitation.

In at least one circumstance, however, the averaging arrangement could have an unfavorable effect. This may be so where the base company owns branch operations, as distinguished from subsidiaries, in two or more countries and one of the branches suffers a loss, say of \$50,000, while the other makes a profit, say of \$100,000 on which it paid \$50,000 in foreign income taxes. In that event, averaging will serve to make the numerator (foreign source net or "taxable income"—\$50,000) of the per-country limitation *less* than the profits of the one profitable branch (\$100,000) which did pay a foreign tax (\$50,000). The effect is to create a greater possibility, in our illustration—a certainty, that the average effective rate of foreign taxes on foreign source income, here 100%, will exceed the effective American rate. The consequent loss of a current credit for part of the foreign tax, assuming a distribution by the base company of the profitable branch's gain, would not have been suffered currently if the operating facilities had been housed in sub-subsidiaries, rather than branches. With a sub-subsidiary organizational structure, averaging on a current basis could have been avoided; foreign source income of the base company and of

^{220a} This difficulty will be less serious if Congress ultimately passes a bill which was approved by the House in the 1960 session but which the Senate did not have time to consider. That bill would reduce the required degree of ownership from 50% to 20%. H.R. 11,681, 86th Cong., 2d Sess. (1960).

²²¹ I.T. Regs., § 1.902-1(c).

²²² I.R.C., § 904, discussed generally in Section C, *supra*.

the American parent would have been based solely on the dividend declared by the profitable operating subsidiary, with the effective foreign tax rate in our illustration being 50%, not 100%.

Because of legislation enacted in late 1960 and discussed more fully in Section F, *supra*, averaging can now also be accomplished without regard to the form of organization, i.e., can even be applied where the American parent itself creates sister facilities in two or more countries. As noted in Section F, an election by such a taxpayer to conform to an "overall" limitation, rather than the per-country limitation, serves as the new statutory device by which that domestic parent would shift to an averaging technique. But if averaging in the setting of that sister-type organizational structure is really important in order to level out high- and low-tax countries, the parent may be confronted with a hard choice at a later point when it contemplates opening a new facility in a yet different foreign country from which, for a few years, it anticipates losses. As noted in the preceding paragraph, averaging these losses in with the older profitable foreign operations may reduce the credit allowed for taxes actually paid those countries in which profitable operations are conducted. Of course, this could be avoided by obtaining the Treasury's consent to revocation of the election to conform to the overall limitation. But the price would be a forfeiture of the right to average the profits from those high- and low-tax countries which house the profitable operations, for revocation would mean that a strict country-by-country approach would be applied as a limitation on *all* foreign operations. This world-wide statutory choice between one or the other type of limitation is not required, however, where averaging of high- and low-tax countries is accomplished solely by reference to organizational structure because of the way the *per-country* limitation itself is interpreted. A parent which had enjoyed averaging only because it had operated through a base company could isolate what will initially be a new loss operation in a yet different country by creating its own facility there, the per-country limitation serving to prevent the loss there from affecting the averaging which is applied to the operations conducted through the base company. Theoretically, and perhaps even from a practical standpoint, this too is not without a price tag. One advantage normally associated with base company operations will be lost. Absent some inter-company loan arrangements, if profits of the base company operations are to be used in creating the new facility, they must first be routed through the parent and become a part of American gross

income, for as previously noted, isolation will be accomplished only if the parent itself creates the new facility. The practical disadvantage of this is not likely to be very great, however, if averaging was really important to the base company operation. That fact alone probably means that the average foreign rate suffered by the base company operations comes fairly close to the American rate, in which event, because of the credit, the additional American tax is not likely to be of overriding significance.

The final operational problem in base company settings involves the policing problem.

Absent distributions to the American parent, transactions between the base company and the operating subsidiaries would not be policed by the Internal Revenue Service under § 482 of the Code. But at the point of distribution to the American parent, it is entirely possible that the Service is free to invoke § 482 in applying the American concept of "accumulated profits" to the various organizational tiers; only in this way could it effectively preserve the integrity of and difference between, the one-tier and two-tier deemed-paid credit arrangements. In this connection, the congressional adoption of an additional policing measure in late 1960 is not without meaning. A new bill clearly establishes the right of the Treasury to obtain from domestic parents various types of information relative to their foreign subsidiaries and sub-subsidiaries, including not only balance sheets, but also data pertaining to inter-company transactions and the make-up of the accumulated earnings and profits of such foreign corporations.^{222a} Moreover, prior to distribution by the base company, inter-company arrangements between it and operating companies would fall within the policing jurisdiction of the foreign countries. Also in this connection, it should not be forgotten that most bilateral tax treaties provide that transactions will be unscrambled for tax purposes if they are not entered into in accordance with standards comparable to those which would be applied by strangers.

(c) *American tax problems peculiarly incident to the creation of a base company.*—The first of the three prime American tax problems immediately incident to the creation of a foreign holding company involves the sweeping response made by Congress to a fairly limited and obviously unwarranted type of avoidance device practiced in the late 1920's and early 1930's. Some taxpayers who owned securities which had increased substantially in value sought

^{222a} Note 194a, *supra*.

to reduce these to cash without suffering any tax whatever. Their first step involved a tax-free transfer of the securities in exchange for the entire stock of a foreign corporation created in a country which did not tax capital gains. In seeking immunity from American tax with respect to this first step, reliance was placed upon a non-recognition provision similar to § 351 of the Code. The foreign holding company would then make a tax-free sale of the portfolio for cash which it then transferred to a newly created American corporation in exchange for all of its stock, the latter being distributed to the original American taxpayer in reliance on the reorganization provisions. Through the new wholly owned American corporation, the taxpayer would now control cash which had been realized without tax cost, provided the judiciary approved the application of the two nonrecognition provisions. In 1932, a congressional committee expressed some doubt as to what the judiciary might do with the latter question;²²³ accordingly, it proposed²²⁴ and the Congress adopted two complementary remedies which literally go far beyond the dimensions of the original problem.

The first such remedy,²²⁵ as currently designed,²²⁶ neutralized the right under § 351 to make a tax-free transfer of appreciated *property* to a controlled foreign corporation unless, before the exchange, it is established to the satisfaction of the Treasury that the exchange is not "in pursuance of a plan having as one of its principal purposes the avoidance of federal income taxes." A like limitation is placed upon the reorganization and tax-free inter-corporate liquidation provisions.²²⁷

Though the practice which gave rise to this grant of administrative discretion involved attempts by taxpayers to avoid the American *capital gain* tax while realizing effective control over *cash*, the statutory language itself—in identifying the type of transfers covered—is sufficiently broad to encompass any transfer of *appreciated* stock in foreign operating subsidiaries to a foreign base or holding company. Moreover, the delegation of administrative discretion would also seem to be sufficiently broad to permit the Commissioner to deny nonrecognition if he determines that one of the principal purposes is to avoid the American tax on future *ordinary* income through use of the base company as a storehouse

²²³ H. Rep. No. 708, 72d Cong., 1st Sess. 20 (1932).

²²⁴ *Ibid.*

²²⁵ Rev. Act of 1932, § 112(k).

²²⁶ I.R.C., § 367.

²²⁷ *Ibid.*

or deflection instrumentality for the profits of operating facilities. In any event, where creation of a base company is postponed until after one or more operating companies have expanded out of retained profits, thus increasing the value of the stock, the Commissioner's determination must first be secured if the American parent is to have any hope for nonrecognition of what would be realized gain on transferring the appreciated stock to the base company. Presumably because the issue in each case is largely one of fact, the Service has refrained from publishing any rulings which otherwise might have served as guideposts.

The second or complementary remedy enacted by Congress in 1932 is similar to the first,²²⁸ except as now written (1) it relates only to a transfer of "stock or securities," (2) it imposes a 27½% *excise* tax on any appreciation in value, and (3) it does not have a supplementary provision which, following application of the tax, steps up the basis of the stock received in the base company.²²⁹ Thus while transfer of a foreign branch operation which had appreciated in value could be prejudiced by the Treasury only under the first provision,²³⁰ a transfer of stock in operating companies could be affected by either provision.

Creation of the base company before stock of the operating facilities has appreciated in value through retained earnings will, of course, avoid the immediate costs described above. It should also be clear that the above provisions will constitute less of a problem where the operating subsidiaries are really sales organizations which do not own substantial assets. Their future profits could be deflected to the base company which might in turn invest them in manufacturing facilities located in the most appropriate country or countries.

But even in the two recited circumstances where nonrecognition of immediate gain will not be a serious problem, it would be wise to see that the holding company actually performs a meaningful control function; otherwise, there is some risk that it may be caught up in any drive which the Service may some day launch in an effort to neutralize—as a recognizable tax entity—any foreign corporation which serves only as a passive receptacle of, and shield for, profits earned by operating sub-subsidiaries.²³¹ While there is nothing to indicate that such a drive is about to be launched, or—assum-

²²⁸ Rev. Act of 1932, § 1250, now I.R.C., § 1491.

²²⁹ I.R.C., § 358 complements §§ 367 and 351, but not § 1491.

²³⁰ I.R.C., § 351, on which § 367 rides "piggy-back," relates to transfers of "property."

²³¹ Cf. Aldon Homes, Inc. 33 T.C. 582 (1959).

ing a "tidy" arrangement—that it would be successful, the same could have been said of Clifford trusts before the Treasury launched what turned out to be a successful attack against them.²³²

By legislation enacted in late 1960, Congress also increased the likelihood that the Treasury would learn of the creation or reorganization of foreign corporations in which American individuals or corporations hold a 5% interest, direct or indirect, or with respect to which Americans will serve as officers or directors. The Treasury is now empowered by regulation to prescribe the contents of an information return which such officers, directors, or stockholders must submit upon the creation or reorganization of a foreign corporation with which they are associated.^{232a} At this writing, the Treasury had not yet had a chance to promulgate such regulations.

The second major American tax problem immediately incident to the creation of a foreign holding company involves licensing arrangements. Assume that the American parent had previously licensed its patents to one or more of the foreign operating subsidiaries. While the deemed-paid credit for foreign income taxes is normally allowed only in connection with the receipt of *dividends*, the discussion in Subsection 4 of Section C, *supra*, indicated, in the absence of dividends, that a credit would be allowed under certain circumstances upon the receipt of *royalties*.²³³ The advantages of that arrangement, as outlined in the previously mentioned Section, will probably be lost if stock of the licensee-subsidiary is transferred to the holding company. According to the Code, this unique credit arrangement is authorized only where an *American* corporation owns "directly or indirectly, 100% of all classes of stock" of the foreign licensee-corporation. Transfer of the latter's stock to the holding company would vest *direct* ownership in a *foreign* entity. While the statutory provision also literally encompasses situations where the American enterprise "*indirectly*" owns all shares in the licensee-corporation, it does not literally incorporate the precise rules of constructive ownership reflected in other parts of the Code. Indeed, certain conditions set forth in the provision seem to suggest that ownership through an intermediate corporation is not con-

²³² *Helvering v. Clifford*, 309 U.S. 331, 60 S. Ct. 554 (1940).

^{232a} Pub. Law 86-780, 86th Cong., 2d Sess. (1960), § 7, amending I.R.C., § 6046. Also enacted was a provision preserving the opportunity to obtain the 85% dividends received deduction with respect to dividends paid out of earnings and profits which were accumulated at a time when a corporation was domestic to the United States, but where the dividend was actually paid after the corporation had taken on a foreign complexion through the tax-free reorganization provisions. Pub. Law 86-779, 86th Cong., 2d Sess. (1960), § 3, amending I.R.C., § 243.

²³³ I.R.C., § 902(d).

templated. And if not, nothing would be gained by entering into a substitute licensing arrangement with the holding company, the stock of which would be "*directly*" owned by an American corporation. The statute specifically prescribes that the 100% ownership must relate to a foreign corporation engaged in "*manufacturing, production, or mining*,"²³⁴ a standard to which a *pure* holding company would not conform. The difficulties just described would be avoided, of course, if the operations were conducted through permanent establishments (branches) of the base company, rather than through sub-subsidiaries.

The third major American tax problem incident to the creation of a foreign holding company involves the case where stock in the American parent is centralized in a very few persons. Viewing this circumstance solely in practical terms, the parent's foreign holding company would be closely akin to a *personal* holding company. At least, since 1937, Congress has thought the similarity to be sufficient in some cases to justify such an equation. The prejudicial quality of that equation stems from the treatment accorded true foreign "*personal*" holding companies.

Such a company is said to exist whenever (1) more than 50% in value of its outstanding stock is owned, "*directly or indirectly*," by or for not more than five American residents or citizens, and (2) at least 60% (in some cases, 50%) of its gross income is so-called "*foreign personal holding company income*," i.e., is derived in the form of dividends, interest, royalties, etc.²³⁵ Generally speaking, when these two standards are met, the foreign personal holding company income is taxable to the holding company's stockholders *whether or not distributed*.²³⁶ This means, when coupled with the complementary doctrine of constructive ownership,²³⁷ that an American parent which owns all of the stock of a *pure* foreign holding company will be taxable on its undistributed earnings if over half the stock of the parent is divided among no more than five stockholders.

This neutralization of the tax advantages otherwise associated with foreign base companies could be avoided if the base company itself also has an active operational function from which it derives sufficient "*gross income*" to enable it to fall short of the second of

²³⁴ *Ibid.* Italics added.

²³⁵ I.R.C., § 552.

²³⁶ I.R.C., § 551.

²³⁷ I.R.C., §§ 554 and 544.

the two previously enumerated definitional standards. But that the active operational function must be truly significant is at once recognizable when account is taken of the fact that the standard is geared to "gross income," not gross receipts. For example, if it engaged only in a selling activity, only that part of its gross receipts in excess of the cost of goods sold would be deemed "gross income" for this purpose.

SECTION H. FURTHER TAX IMPLICATIONS IF A COMMON MARKET FACILITY EXPORTS OUTSIDE THE COMMON MARKET

An American enterprise may contemplate that any Common Market facility which it creates will also export to countries outside the Community. While sub-topic (c) of Section D, *supra*, indicated that any Common Market nation in which the facility might be located would free the export transaction itself from turnover tax, it also noted some variation among member nations in the degree to which any turnover tax previously paid at earlier stages in the production process would be refunded. Comparison of the rates which each might have applied in those earlier stages appears, *supra*, in Section B.

While all Common Market countries in which the facility might be located would more or less free the exported item from the impact of its turnover tax, all would impose an *income* tax on any profit derived by the facility from the export. According to the discussion in Section D, *supra*, a double income tax would not normally be suffered, however, if the goods were sold by the facility directly to customers in *another* member nation. Normally, the latter's income tax would only be applied if a permanent establishment had also been created there. There may be cases, however, where importing nations outside the Common Market will seek to reach the exporter's profit whether or not a permanent establishment of the type heretofore described is maintained therein. To avoid this possibility, Common Market nations have entered into or are negotiating bilateral treaties with a number of non-member nations. The status of such treaties with a number of countries is indicated in Table III U.

TABLE III U

	C—Concluded	N—Under Negotiation
	Austria	
	Denmark	
	Finland	C
	Greece	
	Norway	
	Sweden	C
	Switzerland	C
	United Kingdom	C
	Eire	
	Canada	C
	Egypt	N
	India	C
	Japan	
	Ceylon	C
	Pakistan	C
	New Zealand	N
	South Africa	N
Belgium		
France	C	
Germany	C	
Italy	C	
Luxembourg		
Netherlands	N	

PART IV. THE PROBLEM OF CONVERTING FOREIGN PROFITS AND TAXES INTO AMERICAN DOLLARS, AS IT AFFECTS AMERICAN TAXES ON THOSE ENGAGED IN FOREIGN TRADE OR BUSINESS

SECTION A. INTRODUCTION

Even those American businesses which engage only in *domestic* activity are affected by constant changes which take place in the value of the dollar. Cost of living adjustments in wages scales, pursuant to labor contracts, may be matched on the tax side by realization of, and a tax on, illusory capital gains. Again, predictions regarding future monetary changes may well affect a choice of inventory methods for tax as well as other purposes, leading, illustratively, to the adoption of L.I.F.O. While choices such as this may affect the amount of ultimate tax on a business which confines its endeavors to the United States, from the beginning of American tax history each stage of the computation has always been reflected in terms of American dollars assumed to be stable.

When businesses, accustomed *only* to domestic activity, first began to conduct foreign trade in countries with gold-backed, fully convertible currencies enjoying a stable rate of exchange, their accounting problems did become more involved, but in that earlier day such complications had little American tax significance. Those businesses which paid or accrued their foreign income taxes in a stable, easily converted foreign currency and went through the year without having converted their foreign profits into American dollars did have to resolve such questions as, (1) the choice of a date on which conversion into American dollars would be effected, and (2) in the case of a branch operation, whether the conversion would relate only to foreign profits computed in the manner of domestic profits or would penetrate into the net worth position of the foreign operation, reflecting a profit or loss based on a comparison—in dollar values—of net worth at the beginning and end of the year. But tax-wise these questions were of little practical significance when the British pound was equal to \$4.86 in American money, with a maximum variation of about 2¢ in each direction, and when every reasonable man had the right to believe this state of affairs would continue as an undisputed fact of economic life.

Foreign exchange questions became highly relevant for tax purposes, however, when the devaluation process of foreign currencies set in.

An additional complication developed when blocked or restricted currencies became commonplace. We are familiar with a few American tax concepts which permit deferment of taxes even on certain *domestic* earnings which have been locked up and thus rendered completely unavailable for current use. Employer contributions to pension trusts in which an employee-taxpayer has a vested right furnish the best illustration. Foreign profits reflected in blocked foreign currency added this question of possible deferment to those previously enumerated. Ancillary to it was the further question of whether a deduction for expenses associated with blocked income should also be deferred. Finally, blocked or restricted foreign currency set the stage for three rates of exchange—the official, the black market, and the commercial rate in the United States. The problem of choosing from among these was added to the previous list.

The four sections which follow deal with the more typical tax accounting complications associated with the conversion and deferment problems. The first relates to the method by which foreign profits will be reflected as well as to the timing question, absent blockage or other restriction. The discussion here assumes an understanding, however, of the general tax differences noted in PARTS II and III with respect to direct exports and other foreign operations conducted through a permanent establishment or foreign subsidiary.

The second section concerns the possibility of deferring blocked or restricted foreign profits, while the third focuses on the choice of the market place which will be resorted to for the purpose of fixing the conversion rate.

The last section explores the conversion problem as it affects the credit for foreign income taxes which have been paid or accrued in a foreign currency.

SECTION B. METHOD AND TIME FOR CONVERTING FOREIGN PROFITS INTO DOLLARS, ABSENT BLOCKAGE OR RESTRICTION

(a) *Introductory note.*—For tax purposes, the time and method for converting into dollar values foreign profits tied up in

foreign currency will differ, depending on whether the American business is engaged only in direct exports to foreign customers or instead operates a foreign facility through a permanent establishment or foreign subsidiary. Accordingly, the problem must be discussed separately in these three settings.

(b) *Conversion problem re profits from direct exports to foreign customers.*—There is nothing to indicate that American manufactures engaged in *direct* exports to foreign customers are freed from the usual rule requiring sales to be reflected on an accrual basis for federal tax purposes.¹ Not all such vendors, however, will encounter exchange problems and possible attendant tax complications. Such problems will be avoided, for example, if the American enterprise sells its product to, say, a Netherlands importer who agrees to make payment in American dollars. The need to exchange Dutch guilders for American dollars and the attendant problems associated with rates of exchange rest wholly upon the Dutch firm. Even if the American exporter sells goods under an agreement to accept payment in guilders, it does not necessarily follow that the exchange problem will complicate its tax affairs. The taxpayer may design the transaction so that accrual, payment, and conversion take place on the same date, the overall effect being akin to payment in dollars. In this connection, even accrual basis taxpayers engaged only in domestic business have some control over the time when a sale must be brought into gross receipts. According to the regulations, "a taxpayer engaged in a manufacturing business may account for sales of his product when the goods are shipped, when the product is delivered or accepted, or when title to the goods passes to the customer, whether or not billed, depending upon the method *regularly* employed in keeping his books."² If payment in a foreign currency and conversion into American dollars are normally expected to coincide with delivery, the regulation would permit the latter to be chosen as the occasion for accrual, but presumably only if the taxpayer's books were regularly kept in that manner also with respect to domestic sales. Even where domestic sales have regularly been reflected in gross receipts as of the date of sale, it still might

¹ The regulations do not distinguish between foreign and domestic sales. I.T. Regs., § 1.446-1(c)(i)(iv)(b). The Tax Court has said that a taxpayer who accrued such profits properly reflected the item. *Foundation Co.*, 14 T.C. 1333 (1950), Acq., C.B. 1950-2, 2. While certain general rulings of the Service pick the time of receipt as the pivotal dateline, it is believed that the facts to which those rulings were addressed involved other types of income in the setting of a cash basis taxpayer. *E.g.*, see O.D. 419, C.B. 2, 60 (1920). This was certainly the case in Rev. Rul. 291, C.B. 1953-2, 42, 48.

² I.T. Regs., § 1.446-1(c)(i)(ii). (*Italics added.*)

be possible to design sales to foreign customers so that the benefits and burdens of ownership passed only upon delivery.³

In the absence of some such arrangements, it is possible, though not probable, that in the course of the total transaction, three different rates of exchange may be in effect; at the time of accrual, later at the time of payment in the foreign currency, and still later on the date of conversion into American dollars. A change in the conversion rate, occurring between any two of these events, will complicate the tax problem.

In one sense, the sale transaction itself is closed on the date of accrual; the then conversion rate must be applied to the amount thereafter receivable in foreign currency in order to determine the amount includible in gross receipts. That same rate fixes the basis for the foreign currency when later received.⁴ The fact that the dollar value of the foreign account receivable may have declined as of the end of the taxable year because of a change in exchange rates apparently does not serve, in the eyes of the Internal Revenue Service, to justify a loss deduction for the exporter,⁵ though a contrary rule is now recognized in the case of foreign branch operations.⁶ A second transaction has not yet been closed. Assuming, however, that the American exporter does not thereafter hold the foreign currency, when received, as an investment, subsequent conversion of it into dollars at a different rate of exchange than prevailed at the time of accrual will give rise to further ordinary income or to an ordinary loss, depending on whether intervening changes, if any, in the exchange rate were favorable or unfavorable.⁷

(c) *Conversion problem re profits derived through a foreign permanent establishment.*—Theoretically, and certainly for jurisdictional purposes, § 61 of the Code has always included in the gross income of an American corporation the gross from all sources, foreign as well as domestic. As early as 1920, however, the In-

³ While treaties with 5 of the Common Market countries would guarantee immunity of the profit from foreign income taxes, such an arrangement might lead to multiple turnover taxes. See discussion in PART II, *supra*.

⁴ Foundation Co., 14 T.C. 1333 (1950), Acq., C.B. 1950-2, 2. Cf. Maurice P. O'Meara, 8 T.C. 622 (1947).

⁵ G.C.M. 4954, C.B. VII-2, 293 (1928). Cf. O.D. 590, C.B. 3, 75 (1920) and Joyce-Koeble Co., 6 B.T.A. 403 (1927), Acq., C.B. VI-2, 4. Anderson, Clayton & Co. v. United States, (Ct. Cl. 1958) 168 F. Supp. 542, indicates, however, that the government has on occasion entered into an agreement with taxpayers permitting accounts to be discounted at the end of the year by reference to shifts in exchange rates.

⁶ See discussion in sub-topic (c), *infra*.

⁷ Foundation Co., 14 T.C. 1333 (1950), Acq., C.B. 1950-2, 2.

ternal Revenue Service ruled in O.D. 550 that only the *net* result of a foreign branch's operations need be consolidated with that of the American enterprise in the instance where the branch kept a separate set of records.⁸ This accommodation of the jurisdictional rule to an accounting principle was complemented in the same ruling by a more detailed outline of the accounting technique approved by the Service in determining the net result of the foreign branch's operation. In essence, it established what has been described as the "*profit-and-loss*" method. The branch's profits were to be determined first in terms of the foreign currency, though in accordance, of course, with American law with respect to inclusions, deductions, capitalizable items, etc.⁹ From this figure, remittances during the year—expressed in the foreign currency—were to be subtracted, though these were then to be picked up by the American enterprise at the rate of conversion which applied as of the date of remittance. The balance of the branch's net profits, expressed initially in the foreign currency, were to be accounted for by the American enterprise as of the end of the year, the rate of exchange on that date to be applied in converting the unremitted foreign profits into American dollars.

Under the foregoing method, a branch might show a taxable profit though unfavorable mid-year shifts in the rate of exchange would show that the *dollar* value of its current assets had declined from the beginning to the end of the year. In just such a situation, an American enterprise sought to reflect a foreign branch's operations in accordance with what has become known as the *net worth* or balance sheet method. In short, from the branch's tentative profit—computed first according to a profit-and-loss method, it deducted the dollar amount which its *current* assets had declined in value, from the beginning to the end of the year, solely because of unfavorable changes in exchange rates.

The government argued that this improperly permitted the taxpayer to take advantage of what was essentially an unrealized loss. However, a court sided with the taxpayer; it rejected the notion that foreign currency and other current assets required incident to the operation of a branch engaged, illustratively, in a manufacturing operation should be treated like fixed assets with reference to which an unrealized decline between the two points of time in

⁸ C.B. 2, 61 (1920).

⁹ That American law controls inclusions, etc., see PART III, *supra*.

American-dollar value was admittedly not recognizable for tax purposes.¹⁰ In calling for a comparative translation of the current assets into dollar values at the two points of time, the court agreed that the net worth adjustment was proper with respect to inventories, accounts receivable and payable, cash, and bank deposits, but not, of course, with respect to fixed assets such as land, buildings, and machinery. The latter were to be carried on a dollar value balance sheet at the rate of exchange prevailing at the time of acquisition, and to that same figure the depreciation reserve would also be responsive.

More recently the Tax Court has indicated that the taxpayer really has a choice of methods, the profit-and-loss and the net-worth methods being characterized as the "main approaches."¹¹ Since, within limits, "the question is one of accounting and not of substantive law,"¹² the overriding requirement was said to be consistency in practice. Only in this way will the various methods reflect like amounts over the long haul.¹³

(d) *Conversion problem re dividends derived from a foreign subsidiary.*—A dividend is not the only type of profit which an American enterprise may derive from operations conducted through a foreign subsidiary. Illustratively, the American parent may also sell its own exported products to the foreign subsidiary or treat the latter, at least in part, as a permanent establishment in the nature of a sales agent for those American products not manufactured by the subsidiary. The problem of converting the latter types of profit into American dollars has been considered, however, in the preceding subtopics; attention here is limited to the matter of dividends.

For tax purposes, the date on which an American parent should convert dividends declared in foreign currency is clear enough in the limited instance where the parent otherwise keeps its books on a cash basis. Conversion takes place on the date the dividend is actually or constructively received.¹⁴ Contrary to what others have ap-

¹⁰ *Vietor and Achelis v. Salt's Textile Mfg. Co.*, (D.C. Conn. 1928) 26 F.(2d) 249.

¹¹ *American Pad & Textile Co.*, 16 T.C. 1304, 1310 (1951).

¹² *Ibid.*

¹³ It would appear that long term liabilities should also generally be reflected at the rate prevailing on the date the liability was incurred.

The American Institute of Certified Public Accountants reflects its recommendations with respect to the net-worth method in Bulletin No. 43, Ch. 12, p. 113. A method typically in use is also described in Munsche, *Exchange and Other Problems in Taxation of Foreign Income*, 17 N.Y. INST. 425, 433 (1959). In general, see HEPWORTH, *REPORTING FOREIGN OPERATIONS* (1956).

¹⁴ *Mim.* 5297, C.B. 1942-1, 84; *Frank W. Ross*, 44 B.T.A. 1 (1941); *O.D.* 419, C.B. 2, 60 (1920). Because of the constructive receipt doctrine, the date of payment will be the

parently assumed,¹⁵ the matter is not so clear, however, in the more frequently recurring circumstance where the parent keeps its books on an accrual basis. The difficulty here is not attributable to the foreign character of the dividend; it stems from uncertainty regarding the more basic question of when a dividend derived from an American source is properly accruable.

In this latter connection, at one time the Board of Tax Appeals looked to the declaration date.¹⁶ And in that era, the government failed to raise this particular question in at least one contested case where a taxpayer had used that date in translating foreign dividends into American income.¹⁷ Throughout that period, however, those regulations which dealt specifically with dividends, as distinguished from the more general provisions bearing on accounting methods, failed to distinguish between shareholders whose books were kept on the accrual basis rather than on the cash basis.¹⁸ Dividends were said to be "included in the gross income of the distributees when the cash or other property is unqualifiedly made subject to their demands."¹⁹ This meant the date on which the dividend was payable except in the instance where the item could not be said to have been constructively received on that date,²⁰ in which case the actual date of receipt governed. This shotgun type of regulation led the Court of Appeals for the Second Circuit to reverse in 1942 the historical position of the Board.²¹ By the previously quoted regulation, dividends were said to have been carved out for treatment which differed from that associated with other income items, reflection of which was generally determined by reference to the taxpayer's regular method of accounting. The appellate court ignored the declaration and record dates, choosing instead the date of payment and receipt which, in this case, happened to coincide.

The Tax Court (known before 1942 as the Board of Tax Appeals) thereafter noted that "certainty of the answer" was most

critical point if the payment is then unqualifiedly subject to the parent's demand. I.T. Regs., § 1.451-2(b).

¹⁵ See Johnson, *Foreign Tax Credit*, INSTITUTE ON PRIVATE INVESTMENTS ABROAD: SOUTHWESTERN LEGAL FOUNDATION 45, 79 (1959); Munsche, *Exchange and Other Problems in the Taxation of Foreign Income*, 17 N.Y. INST. 425, 427 (1959).

¹⁶ Archer M. Campbell, 6 B.T.A. 60 (1927), Non-acq., C.B. VI-2, 8; Tar Products Co., 45 B.T.A. 1033 (1941), rev'd. (3d Cir. 1942) 130 F.(2d) 866.

¹⁷ Bon Ami Co., 39 B.T.A. 825 (1939). But cf. Mim. 5297, C.B. 1942-1, 84 at 86.

¹⁸ E.g., see I.T. Regs. 118, §§ 39.42-3 and 39.115(a)-1(d).

¹⁹ I.T. Regs. 118, § 39.115(a)-1(d).

²⁰ The regulation included an illustration in which the constructive receipt doctrine would not be applied.

²¹ Tar Products Corporation v. Comm'r., (3d Cir. 1942) 130 F.(2d) 866, rev'g. 45 B.T.A. 1033 (1941).

important; for this reason, it chose not to reconsider "the relative merits of the opinion of the Circuit Court of Appeals and our own." It adopted the view of the former.²² Its new position was affirmed on appeal by a quite different court of appeals, that of the seventh circuit.²³ While the Supreme Court during the period of the 1940's did not go beyond saying that dividends do not in any event accrue prior to the record date,²⁴ it is of some significance that the previously mentioned decision by the Court of Appeals for the Seventh Circuit, postponing inclusion to the date of payment, was selected for publication by the Internal Revenue Service in its own Cumulative Bulletin, a fact which usually meant that the government intended to follow the result.²⁵

On the basis of the foregoing, one might conclude with some assurance that an accrual basis taxpayer resolves the timing question, as it relates to inclusion of dividends, in the same manner as cash basis distributees. The one note of caution relates to a slight change made in the new regulations issued under the 1954 Code. While the statute itself was not changed in any respect relevant here, and while the new regulations do incorporate the statement previously quoted,²⁶ they go on now at another point to say that the constructive receipt doctrine is not generally applicable if, e.g., an item would be accruable at a different date under the taxpayer's regular method of accounting.²⁷ At least one writer has suggested that by this device the government may attempt to re-open the accrual question as it relates specifically to dividends.²⁸

In any event, apart from the matter of dividends and contrary to the case where operations are conducted through a foreign branch, the American parent will not be permitted to take advantage of any shift, resulting from movement of exchange rates, in the dollar value of the foreign subsidiary's current assets.²⁹ The two are separate entities for American tax purposes. Nor may the American corporation revalue at year's end its own accounts receivable running against

²² American Light & Traction Company, 3 T.C. 1048, 1050 (1944).

²³ (7th Cir. 1946) 156 F.(2d) 398.

²⁴ Putnam Estate v. Comm'r., 324 U.S. 393, 65 S. Ct. 811 (1945).

²⁵ Ct. D. 1678, C.B. 1946-2, 135. The government also withdrew the non-acquiescence previously published in 1944 C.B. 32 with reference to the Tax Court's decision. See C.B. 1946-2, 1.

²⁶ I.T. Regs., § 1.451-2(b).

²⁷ I.T. Regs., § 1.451-1(a).

²⁸ RABKIN AND JOHNSON, FEDERAL INCOME, GIFT AND ESTATE TAXATION § 21.04(7), (1954).

²⁹ G.C.M. 4954, C.B. VII-2, 293 (1928), cited with approval in American Pad & Textile Co., 16 T.C. 1304, 1310, Note 2 (1951).

the subsidiary in order to reflect changes, since the date of sale, in exchange rates.³⁰

SECTION C. TIMING THE REFLECTION OF BLOCKED OR RESTRICTED FOREIGN PROFITS

(a) *Introductory note.*—Fiscal manipulations by foreign countries have usually coincided with wars and depressions—local or world-wide. Restrictions have run the gamut, ranging, *inter alia*, from a series of varying limitations on extraction of profits by foreigners—including American enterprises—to complete blockage of those profits. Not until the world-wide economic crisis of the 1930's were the American tax implications of these restraints considered, however, by the judiciary. And even the cases decided in that era were few in number; the only important conclusion was to the effect that a total lock-up justified deferral of income which otherwise would have been deemed realized. Later decisions during World War II indicated, on the other hand, that certain less severe restrictions would not justify a deferral. That period, characterized by restraints of all sorts, did not, however, bring forth meaningful administrative rulings to reduce the sizeable no-man's land in between the two results; the regulations were amended only for the purpose of assuring that deductions and credits would be linked to income properly deferred. But post-war restrictions did bring forth administrative guidelines as precise as could be expected.

As indicated elsewhere in this volume, currency restrictions imposed in Common Market countries today are not nearly so serious as those of an earlier time; comparatively speaking, profits from licensed investments enjoy unusual freedom. Nevertheless, the discussion below of the way American tax law has evolved in response to various types of restrictions is not wholly academic, for times can change. Moreover, there are other kinds of profits with reference to which restrictions are more significant.

(b) *Circumstances calling for deferral of income.*—In 1937, the Supreme Court concluded in one case, contrary to the usual rule, that a *domestic* exchange out of which the taxpayer received

³⁰ *Ibid.* Cf. Appeal of Louis Roessel & Co., Ltd., 2 B.T.A. 1141 (1925); Appeal of Theodore Tiedmann & Sons, Inc., 1 B.T.A. 1077 (1925). But Anderson, Clayton & Co. v. United States, (Ct. Cl. 1958) 168 F. Supp. 542, does indicate that on occasion the government has entered into an agreement permitting accounts between a parent and subsidiary to be revalued at year's end by reference to the then prevailing rate of exchange.

certain peculiarly circumstanced stock did not furnish an appropriate occasion for tax reckoning.³¹ The decision rested on a finding that these particular shares did *not* have a "fair market value, capable of being ascertained with reasonable certainty," and "in the absence of such value, the ownership of the shares did not lay the basis for the computation of gain. . . ." ³² The difficulty was attributable "to their highly speculative quality and to the terms of a restrictive agreement making a sale thereof impossible. . . ." ³³

Within 3 months, the theory embodied in that decision was applied by the Board of Tax Appeals to the first case which had come before it involving restricted foreign profits, *International Mortgage and Investment Corporation*.³⁴

A bank crisis in the early 1930's had led the German government to prohibit the transfer of marks out of Germany. While on the next to the last day of the taxable year, that government did establish a procedure whereby, upon permission, blocked marks could be reinvested on a long-term basis in Germany, repayment on any such reinvestment was also blocked. The Board of Tax Appeals also found as a fact that no market existed within the taxable year for such marks and "no one could form an opinion as to their value at that time." ³⁵

In this setting, the Board determined that an American enterprise was not presently taxable even though it had realized a profit in German marks upon disposition of a German investment. The result was bottomed on the fact that "income for our Federal income tax purposes is measured only in terms of dollars," ³⁶ and here the taxpayer's profit was simply "not measurable in terms of dollars." ³⁷

Foreign profit realized by the same taxpayer from other dispositions which took place during the same taxable year, but *prior* to the blockage, were, however, included in its gross income though, through failure to effect a timely conversion into dollars, those profits were also entrapped by the subsequently adopted monetary restrictions. It was enough that the taxpayer had unrestricted power

³¹ *Helvering v. Tex-Penn Oil Company*, 300 U.S. 481, 57 S. Ct. 569 (1937).

³² *Id.* at 499.

³³ *Ibid.*

³⁴ 36 B.T.A. 187 (1937).

³⁵ *Id.* at 189.

³⁶ *Id.* at 190.

³⁷ *Ibid.* Accord, *Stuart, James & Cooke, Inc.*, P-H B.T.A. Memo. Dec., para. 38-095 (1938). A like result was later reached in *United Artists Corporation of Japan*, 3 T.C.M. 574 (1944) though the blocked item was actually on deposit in a San Francisco branch of a Japanese bank. See note 47, *infra*.

to convert at the moment the profit was realized in the foreign currency.

While the Internal Revenue Service did file an acquiescence to that part of the Board's decision which allowed the taxpayer to defer income realized in blocked German marks,³⁸ it took a different view of the problem in later taxable years as the German government began to relax its currency restrictions.

In *Credit and Investment Corporation*,³⁹ the taxpayer failed to show that it could not have obtained permission to take out of Germany certain marks which it had realized on disposing of an asset, which marks—because of the various uses to which they could be put—did have some market value on the New York exchange though in an amount less than the official blocked rate. Indeed, in that same taxable year it had used that market place to convert certain other restricted German marks. In deciding against the taxpayer, the Board drew a distinction between this situation and that presented earlier in the *International Mortgage and Investment Corporation* case. In the latter case, contrary to the situation here, it had been shown that the taxpayer could not obtain permission to transfer any of its marks out of Germany and, because of the nature of the restrictions on their use, no outside market place catered to such marks.⁴⁰

That the government accepted the distinction between the two cases, and recognized that the earlier decision which was adverse to it still retained its vitality, was demonstrated by its promulgation, at approximately this same time, of a ruling wherein it acknowledged that certain types of profit tied up in blocked British pounds were not presently includible for federal income tax purposes.⁴¹ And this was so though the blocked profits could have been reinvested in British securities, interest on which could have been converted. Otherwise, however, the government did not attempt at this stage in history to chart a more exacting line between deferrable and non-deferrable income insofar as the matter turned on foreign monetary restrictions. Its more or less concurrent amendment of the regulations was confined to the other side of the ledger and was predicated

³⁸ Acq., C.B. 1937-2, 15.

³⁹ 47 B.T.A. 673 (1942).

⁴⁰ The importance of the burden of proof was the center of the court's focus in *Corn Products Refining Co. v. Comm'r.*, (2d Cir. 1954) 215 F.(2d) 513 where the taxpayer sought to include a dividend which the government claimed was blocked. The government prevailed.

⁴¹ Mim. 5297, C.B. 1942-1, 84.

on the conclusion that, in a given case, foreign income had been properly excluded because of "monetary exchange, or other restrictions imposed by a foreign country." In such event, the deductions and credits attributable to such excluded items were also to be postponed, account being taken of them proportionately as and if the deferred income items properly became includible in gross income.⁴²

Before the government again spoke administratively, separate arms of the judiciary evolved in one case two other reasons for denying deferment to foreign income which suffered from some restriction. In *Phanor J. Eder*,⁴³ the Service assessed a deficiency against a lawyer-stockholder by reference to the *undistributed* income of a foreign personal holding company domiciled in Colombia. In connection with his practice, the lawyer-stockholder had spent two months of the year in that Latin American country.

While the exchange laws and regulations of Colombia prohibited the company from transferring its profits or pesos outside that country, the "spending or investment of pesos within" the country were not restricted. But if articles bought with pesos were sold outside the country, the vendor was obligated to return the sales proceeds to Colombia.

None of these latter circumstances, involving the exact nature of the exchange restrictions, seemed important to the Board of Tax Appeals. It was enough that Congress—in attempting to thwart avoidance—had *specifically* called for a tax on stockholders with reference to any undistributed income of a foreign personal holding company.⁴⁴ The fact that such income would have been blocked, had it been distributed as a dividend, was thought to be beside the point. The immunizing philosophy of the earlier *International Mortgage and Investment Co.* case had to give way in the face of such specific legislation.

An appellate court was not satisfied to rest only on this theory. It denied that "inability to expend income in the United States, or to use any portion of it in payment of income taxes, necessarily precludes taxability."⁴⁵ Of importance was the fact that the taxpayers "could have *invested, or spent*, the 'blocked' pesos in Colombia and, as a result, could there have received economic satisfaction." The fact that the taxpayer himself spent a part of the year

⁴² T.D. 5281, July 12, 1943, C.B. 1943, 213 amending I.T. Regs. 103, §§ 19.43-1 and 19.131-6, reflected now in I.T. Regs., §§ 1.461-1(a)(4) and 1.905-1(b).

⁴³ 47 B.T.A. 235 (1942).

⁴⁴ Revenue Act of 1938, § 337, now I.R.C., § 551 et seq.

⁴⁵ *Eder v. Comm'r.*, (2d Cir. 1943) 138 F.(2d) 27.

in Colombia suggested that it was actually necessary for him to expend "some" pesos in Colombia.

This theory, geared to a power to obtain economic satisfaction through foreign reinvestment or other expenditure, necessarily called for an appraisal of the value of that potential satisfaction—but in terms of American dollars. The court suggested that this might be accomplished through a comparison of various price indices prevailing in the United States and Colombia. To this end, the case was remanded to what had now been renamed the Tax Court, and it proceeded to make the comparison in question, though account was also taken of expert testimony the basis for which was not disclosed.⁴⁶

The loosely worded suggestion by the court of appeals, to the effect that deferment was not available if the blocked income could be "*reinvested* or spent" in the foreign country, may have contributed to the government's effort thereafter to sustain a 1938 deficiency against a corporate taxpayer the foreign profits of which were tied up in Japanese yen. For at least part of the taxable year, that corporation could have reinvested the yen in Japanese securities—a practice then frowned upon by the State Department, or in items deemed essential to Japan—such as scrap iron, provided a permit authorizing the purchase could be obtained from that government. These circumstances did not, however, impress the Tax Court. It distinguished the *Eder* case on its own original theory, to the effect that the question of blockage was irrelevant there because of specific legislation which called for a tax on stockholders of a foreign personal holding company without regard to the question of distribution. Deferment of the blocked yen here was deemed justified because the taxpayer did not have " 'unrestricted use and enjoyment' " of his gain.⁴⁷

It was after this decision, in the setting of post-war foreign monetary restrictions, that the government made it possible for taxpayers to obtain assurance that it would not attempt to deny deferment because of a power to reinvest blocked foreign profits. The device, established in Mimeograph 6475,⁴⁸ involved what was described

⁴⁶ 3 T.C.M. 460 (1944).

⁴⁷ United Artists Corporation of Japan, 3 T.C.M. 574 (1944). Later on in the same taxable year, an agreement was reached with the Japanese government pursuant to which the blocked yen could be converted into dollars, but these had to be placed in a non-negotiable deposit for 3 years, without interest, with a San Francisco branch of a Japanese bank. The Tax Court thought that deferment was still justified.

⁴⁸ C.B. 1950-1, 50. Subsequent amendments appear in Mim. 6494, C.B. 1950-1, 54, and in Mim. 6584, C.B. 1951-1, 19.

as a method of accounting which, under prescribed conditions, taxpayers might elect with respect to "deferable income." This classification included that income which, "owing to monetary exchange or other restrictions imposed by a foreign country, is not readily convertible into United States dollars or into other money or property which is readily convertible into United States dollars."⁴⁹

Such income could be deferred until the *earlier* to occur of any one of three events, i.e., (1) until that point when the item no longer satisfied the definition of deferable income, or (2) until the item was in fact converted into dollars or into property readily convertible into such, or (3) until it was used for nondeductible personal expenses, was disposed of by way of gift, bequest, device, or inheritance, or by dividend or other distribution, or, in the case of a resident alien, a taxpayer terminated his residence in the United States.

On the one hand, the first of the three possibilities demonstrated that actual conversion into dollars of previously blocked income was not a *sine qua non* to taxability. It was enough that the item became "readily convertible." On the other hand, it was equally clear from this mimeograph, as well as from a complementary ruling of the same year,⁵⁰ that actual reinvestment, as well as the power to reinvest, in foreign investment or business property did not, standing alone, serve to take blocked profits of an electing taxpayer out of the deferable class. Nor would the mere existence of a power to use the foreign currency for foreign personal expenses prohibit deferment, provided the amounts were not in fact so used. While no mention is made of the circumstance where deferable income is used to pay off foreign loans repayable in foreign currency, it could be argued that deferment should still be allowed *if* the loan was obtained after blockage set in and was invested in investment or business property. In such circumstance, deferment would have been allowed if the blocked foreign currency had been used to make the investment in the first instance. In other circumstances, such as where the loan was obtained prior to restrictions on foreign currency, the government could argue that the loan transaction was a separate and closed matter when repaid, justifying inclusion of the funds previously deferred because of blockage.

(c) *Circumstances requiring deferral of deductions and credits.*—As noted *supra*, the regulations were amended in 1943 so

⁴⁹ *Ibid.*

⁵⁰ I.T. 4037, C.B. 1950-2, 31.

as to require deferment of deductions and credits attributable to any income properly deferred because of exchange controls.⁵¹

The later promulgated Mimeograph 6475 elaborated on this principle as applied to taxpayers invoking the benefits of the method of accounting there prescribed.

Depreciation, obsolescence, and depletion, when measured in terms of foreign currency, were to be taken into account, like other expenses incurred in foreign currency, in subsequent taxable years in the same proportion as the deferrable income, to which they were linked, was includible in taxable income. Where blocked foreign profits were reinvested abroad in investment or business property, a complementary ruling indicated that such property originally took on a deferred income basis measured by its cost in terms of the foregoing currency.⁵² It was contemplated that an annual *information* return covering blocked income would reflect that basis as well as adjustments thereto, such as depreciation, allowed by the Code. When the foreign currency originally used to acquire the assets took on a non-blocked status, two steps were to be taken. First, the original amount so devoted was to be translated into American dollars at the exchange rate prevailing when the funds became unblocked, that amount then being includible in gross income. Second, the adjustments made in the property acquired, as well as the funds originally used to make the acquisition, would be converted at the same rate as that applied in fixing the amount of income; the resulting figure established the basis for the property.

The deferment principle also included costs and direct expenses incurred in American dollars, to the extent attributable to deferrable income. As the proceeds became unblocked, the *entire* cost of goods sold in a given transaction was to be recovered first, before any amount was includible in gross income. Only after those costs were recovered was account to be taken of other direct dollar expenses attributable to the sale. Even then, absent permission to do otherwise, these expenses, unlike the cost of goods sold in the transaction, were to be taken into account proportionately by reference to the relationship which the amount included in gross income during that taxable year bore to the transaction's total proceeds in excess of the cost of goods sold.⁵³

⁵¹ See note 40, *supra*.

⁵² I.T. 4037, C.B. 1950-2, 31.

⁵³ The mimeograph provided for a special arrangement as to these costs if more than one foreign country was involved in the transaction. See para. 7(b) of the mimeograph as amended by Mim. 6494, C.B. 1950-1, 54.

Deferment of the foregoing costs and expenses incurred in dollars will also cease, of course, if the items reflecting the deferable income become worthless.

The mimeograph does not call for deferment of indirect expenses incurred in dollars. Absence of any mention of them presumably means that the taxpayer will not be required to undertake the complicated task of unscrambling these for purposes of affecting allocation to particular transactions only some of which may involve the problem of blockage.

(d) *Mechanics and effect of election under Mimeograph 6475.*—The mimeograph, as amended, calls for the election to be made “no later than the time prescribed by law (including any extension thereof) for filing the income tax return for the first taxable year for which the election is to be applicable.”⁵⁴

Along with his regular return, the taxpayer is required to file separate information returns, on the same type of form, with respect to each country in which a deferable account exists. On these returns, which must be labelled “Report Of Deferable Foreign Income, pursuant to Mimeograph No. 6475,” the taxpayer must enter into two agreements: (1) that the deferable income will be included in taxable income in that taxable year in which it ceases to be deferable under the provisions of the mimeograph, and (2) that no claim will be made that such deferable income was includible in gross income for any earlier year. While like agreement need not be expressly entered on the return with reference to losses, the mimeograph itself does provide that taxpayers electing this method of accounting must also treat losses in a consistent manner.⁵⁵ Finally, once the election is made, it may not be changed without securing the consent of the Commissioner.

By way of general summary, the taxpayer’s gross receipts in blocked foreign currency is reported, though only for information purposes, and the cost of goods sold—in terms of such currency—are subtracted. From the resulting figure—foreign currency gross income—expenses incurred in terms of the foreign currency are deducted in arriving at foreign currency net income.

When some part of the foreign currency net income ceases to be deferable by reference to the standards previously indicated, that amount is reduced by the dollar costs attributable to that transac-

⁵⁴ Mim. 6584, C.B. 1951-1, 19, amending para. 9 of Mim. 6475.

⁵⁵ That the election is binding with regard to losses even in the instance where books regarding foreign profits are otherwise kept in accordance with the net worth method, see *Anderson, Clayton & Co v. United States*, (Ct. Cl. 1958) 168 F. Supp. 542.

tion, the remainder being included in the taxpayer's gross income from which dollar direct expenses, as previously explained, are deducted in turn on a proportionate basis. The Service has also taken the position that a partial remittance of unblocked income covering several years is to be reported, as it becomes unblocked, on a first-in-first-out basis.⁵⁶

(e) *Conclusion.*—The foregoing discussion suggests that Mimeograph 6475 permits restricted foreign income to be deferred in some instances where deferment might not have been permitted under case law. Certainly the right to reinvest in foreign investment or business property without loss of the deferment privilege would not have been permitted by the court of appeals which decided the previously discussed *Eder* case. It was, perhaps, because of this variation that the government characterized the mimeograph as descriptive only of a "method of accounting." While prior cases in this precise area had approached the problem as though it involved a question of law, other cases in related areas have stated that reflection of profits in foreign currency poses an accounting question for which there may be more than one answer—provided the taxpayer follows a sensible practice consistently.⁵⁷ In any event, there is also authority to the effect that taxpayers who elect to be treated under the mimeograph must also be consistent in abiding by its various provisions though one or more may operate to his prejudice.⁵⁸

It is also true that the mimeograph provides a more comprehensive set of answers with reference to the overall method it prescribes than is available under case law. This is so even though the Service could not be perfectly precise in resolving the most basic of all questions. The range of conceivable variations in factual patterns quite rightly restrained it from saying anything more precise than that deferable income consisted of that which was not "readily convertible" into dollars.

Taxpayers remain free, of course, to ignore the mimeograph, falling back on the less precise case law pattern. And particularly in these cases, the question will arise: What market place is to be chosen for valuation of foreign currency in the event deferment is not to be allowed in a given case? This is the subject matter of the next section.

⁵⁶ Rev. Rul. 57-379, C.B. 1957-2, 299.

⁵⁷ *E.g.*, see *American Pad & Textile Co.*, 16 T.C. 1304 (1951).

⁵⁸ *Anderson, Clayton & Co. v. United States*, (Ct. Cl. 1958) 168 F. Supp. 542.

SECTION D. CHOICE OF MARKET PLACE IN DETERMINING THE CONVERSION RATE

(a) *Introductory note.*—At some point, foreign profits and the amount of foreign income taxes paid must be reflected in dollars for American tax purposes. Particularly where a foreign country's currency is blocked or restricted, differences may well exist between that country's official rate of exchange, its black market rate, and the commercial rate at which such foreign money is transferable in the United States. Thus, if the income cannot be deferred for American tax purposes under the principles set forth in Section C, *supra*, it may be necessary to determine which of these several market places will be resorted to in fixing the conversion rate.

As indicated below, the government has not always maintained a consistent position, though in all but two significant cases it has fostered the official rate, a view for which the courts have generally substituted the American commercial rate. The fact that the government has acquiesced in all of the Tax Court cases which were adverse to its position and that the matter has not been further litigated within the past five years may be some indication that it is prepared to accept what may seem to be inevitable. On the other hand, its most recent published ruling, as described below, is so equivocal that it might feel free to argue, without embarrassment, that those acquiescences rested on the peculiar facts of the litigated items.

About half of the litigated items have concerned the estate or gift tax, rather than the income tax, but the Tax Court has insisted that common principles apply to all three and has indiscriminately commingled citations.

(b) *Evolution of relevant developments.*—In 1920, the Service's then Committee on Appeals and Review found the abnormal conditions associated with foreign exchange during the World War I sufficient cause to justify authorizing a taxpayer to "convert current assets less current liabilities payable in the foreign currency at the current rate of exchange or at any rate less favorable to him."⁵⁹ But it then went on to drain most of the vitality from this notion by adding an equivocal caveat, "The Commissioner should consider in any case applications to adopt a rate more favorable to

⁵⁹ A.R.R. 15, 2 C.B. 60 (1920).

the taxpayer *or* may on his own motion apply such a rate where the facts in the particular case warrant such departure.”⁶⁰

The government did not again speak for publication until 1941; in the interval, the elasticity of its earlier position was seemingly unchanged in such private rulings as were reported by recipients. In one, the government is said to have called for the selection of that market place which would most clearly reflect the income,⁶¹ and in another it was said that there could be no general rule, for each case turned on its own peculiar facts.⁶²

The peculiar facts deemed important by it in connection with the British government's restrictions on exchange during World War II turned out to be the effectiveness of the British restraining orders. Required compliance reached the point where there was said to be “little ‘free sterling exchange’ ” and “little difference between the controlled ‘official’ exchange rate and the ‘free exchange’ rate on sterling still available on open market.”⁶³ In that circumstance, with respect to those unblocked accounts for which the British government would permit an exchange, but only at the official rate, the Service insisted that “the rates of exchange, both for conversion of British current assets at the beginning and end of the taxable year and for conversion of British taxes paid with respect to the income involved, either for foreign tax credit purposes or deduction from gross income in the taxpayer's United States return, should be taken at the ‘official’ rate” except where *actual* realization had taken place at some other rate.⁶⁴

A year later, however, the government—in I.T. 3568—was still insisting that the overall problem could not be reduced to a general rule. In rejecting the notion that exchange rates certified by the Federal Reserve Bank of New York for customs purposes could be used in all cases, it stated:

Notwithstanding present conditions of disturbances and the control of trading and exchange by foreign countries, free or open market rates lower than either official or controlled rates were in certain cases realizable on December 31, 1941, dependent upon regulations of the particular foreign country and the degree of control which was

⁶⁰ *Ibid.* (Italics added.)

⁶¹ Cohen, *Tax Accounting Problems in International Operations*, 18 N.Y. INST. 293, 300 (1960).

⁶² Roberts, *Effect of Blocking of Currency on Gain or Loss*, 7 N.Y. INST. 1224 (1949).

⁶³ *Mim.* 5297, C.B. 1942-1, 84 at 86.

⁶⁴ *Ibid.*

exercised. In any case in which conversion rates as of that date are to be used, such rates shall be those giving a result most clearly reflecting the proper amounts of the items to which they relate as affected by the conditions and available means and rates of conversion as of that date. The rates of exchange used will be subject to verification and check upon the examination of the taxpayer's books and records by internal revenue agents.⁶⁵

More or less simultaneous with the publication of that ruling, the government litigated a case involving blocked German marks. And there it sought *to reduce the taxpayer's claimed loss* on a sale by arguing that his basis for the property—purchased by the taxpayer with blocked German marks acquired from an earlier sale—should be determined by reference to the *commercial* rate of exchange prevailing in New York at the time of his purchase, rather than by reference to the official rate. The Board of Tax Appeals agreed, noting that while the marks were blocked at the time the taxpayer originally purchased the property, he would not have been prevented from disposing of those marks on the available New York market.⁶⁶

At approximately the same time, in an effort *to increase the amount of a different taxpayer's profit*, the government shifted its support to the official rate by applying to blocked income that rate which the foreign government itself allowed on unblocked or unrestricted income. Before the Tax Court, the taxpayer had conceded this issue,⁶⁷ arguing only that he should not be subject to any tax. On appeal, however, the Court of Appeals for the Second Circuit remanded the case on the valuation issue, concluding that the value of blocked foreign currency was not on a par with unblocked income in the same currency.⁶⁸ In the absence of a regular New York market, the Tax Court then accepted the testimony of a New York banker to the effect that income so restricted was worth half of the rate which was available for unblocked income originating in that same country.⁶⁹

⁶⁵ C.B. 1942-2, 112.

⁶⁶ Credit and Investment Corporation, 47 B.T.A. 673 (1942). Also, Foundation Co., 14 T.C. 1333 (1950), Acq., C.B. 1950-2, 2.

⁶⁷ Phanor J. Eder, 47 B.T.A. 235, 238 (1942).

⁶⁸ Eder v. Comm'r., (2d Cir. 1943) 138 F.(2d) 27.

⁶⁹ Phanor J. Eder, 3 T.C.M. 460 (1944). The same approach was made in Estate of Anthony H. G. Fokker, 10 T.C. 1225 (1948), Acq., C.B. 1948-2, 2 and Estate of Oei Tjong Swan, 24 T.C. 829 (1955), Acq., C.B. 1956-2, 8. In the latter case, the court stated (at 880): "In other words, if an amount had actually been realizable in United States dollars, our holding would have been based thereon; but since there could have

In a similar case decided by the Tax Court four months later, the government had again espoused the cause of the official rate, opposing application of the less attractive established New York commercial rate. While a Brazilian administrative agency apparently had authority to redeem the taxpayer's milreis at the official rate, the evidence indicated that this authority was seldom if ever granted in the type of case at bar and that in fact the taxpayer had resorted to the New York exchange in earlier dealings. The Tax Court was now content with the statement that "Taxation is a practical matter. We apply the commercial rate."⁷⁰ The Court of Appeals for the Second Circuit affirmed.⁷¹

This principle was then extended by the Tax Court to gift⁷² and estate tax⁷³ situations. In the former, for example, a California banker appeared as an expert witness, testifying that his bank had bought and sold such blocked currency for an amount approximating 50% of the official rate for unblocked currency of that country. This ratio was then adopted by the court. Those decisions were thereafter cited as authority for the resolution of income tax cases, the Tax Court stating that the change in setting "makes no difference in the fundamental question involved."⁷⁴

Only where the taxpayer did not raise the issue,⁷⁵ or where the higher official rate was actually available,⁷⁶ has the Tax Court accepted the government's recurring efforts to apply the official rate. As previously suggested, the government's acquiescences to other adverse holdings and its failure to litigate a case since 1955 may indicate that the question is now considered settled.

been no realization of dollars in respect to the blocked assets under consideration, it is necessary to translate foreign value into dollars for estate tax purposes by conversion at an appropriate rate of exchange which will reflect the various restrictions and other factors impinging on value."

⁷⁰ *Edmond Weil, Inc.*, 3 T.C.M. 844, 849 (1944).

⁷¹ (2d Cir. 1945) 150 F.(2d) 950.

⁷² *Morris Marks Landau*, 7 T.C. 12 (1946), Acq., C.B. 1946-2, 3.

⁷³ *Estate of Ambrose Fry*, 9 T.C. 503 (1947), Acq., C.B. 1948-2, 2. Also, *Estate of Jan Willem Nienhuys*, 17 T.C. 1149 (1952), Acq., C.B. 1952-1, 3.

⁷⁴ *Ceska Cooper*, 15 T.C. 757 at 765 (1950), Acq., C.B. 1951-1, 2; *Foundation Co.*, 14 T.C. 1333 (1950), Acq., C.B. 1950-2, 2.

⁷⁵ *Waterman's Estate*, 16 T.C. 467 (1951), rev'd. on another issue, (2d Cir. 1952) 195 F.(2d) 244; *Max Freudmann*, 10 T.C. 775 (1948).

⁷⁶ *Estate of Ambrose Fry*, 9 T.C. 503 (1947) re account in Barclays Bank. The official rate was also applied to an army officer stationed in England and France because the blocked foreign currencies which he received there at the official rate could be converted into dollars at the higher official rate upon his departure from those countries. *S. E. Boyer*, 9 T.C. 1168 (1947). Cf. *Ceska Cooper*, 15 T.C. 757 (1950), Acq., C.B. 1951-1, 2.

SECTION E. CONVERSION PROBLEM AS IT AFFECTS THE CREDIT FOR FOREIGN INCOME TAXES

(a) *Introductory note.*—As explained in PART III, *supra*, an American taxpayer is allowed a credit for any foreign income taxes actually borne by him (so-called direct tax credit)⁷⁷ as well as, in the case of an American corporation, a portion of those paid or deemed paid by a foreign corporation at least 10% of the voting stock of which is held by the domestic corporation (so-called “deemed paid” tax credit).⁷⁸ In both instances, the foreign tax will normally be payable in a foreign currency. But because the time when the amount so paid must be converted into American dollars differs by reference to the two types of credit, the conversion problem is discussed separately as to each.

(b) *Conversion for purposes of the direct tax credit.*—Shortly after the credit for foreign income taxes was established, the Commissioner ruled that *cash basis* taxpayers who paid such in a foreign currency should compute the credit by converting the amount paid into American dollars by reference to exchange rates prevailing on the date of payment.⁷⁹

In that same period, as to a deductible *domestic* tax, the government was contending that *accrual basis* taxpayers should reflect the item in the year in which the events occurred “which fix the amount of the tax and the liability of the taxpayer to pay it”⁸⁰ even though the tax might not yet be due and payable. Only then was it thought that such a taxpayer would be reflecting his true income for the period. This concept, as applied to accrual basis taxpayers, was carried over by the government to the direct credit for foreign income taxes. Since the governing provision authorized an accrual of the credit,⁸¹ where such foreign tax had not been paid during the year the rate of exchange in effect on the last day of the year was said by the government to be the basis by which the foreign liability was to be converted into American dollars.⁸²

⁷⁷ I.R.C., § 901. As explained in PART III, this credit also includes war profits and excess profits taxes as well as any tax paid in lieu of these and income taxes otherwise generally imposed. I.R.C., § 903.

⁷⁸ I.R.C., § 902.

⁷⁹ I.T. 1645, C.B. II-1, 141 (1923).

⁸⁰ *United States v. Anderson*, 269 U.S. 422, 441, 46 S. Ct. 131 (1926).

⁸¹ Revenue Act of 1921, § 238(b), now I.R.C., § 905(c).

⁸² I.T. 1645, C.B. II-1, 141 (1923).

The earliest statutory provision,⁸³ like that on the books today,⁸⁴ also provided that the domestic tax for the "year or years affected" would later be redetermined in the event the amount of foreign tax subsequently paid by the accrual basis taxpayer differed from that previously estimated and accrued as of the end of the original taxable year. The government concluded that this statutory arrangement had the effect of establishing a superseding conversion rate in such cases, the effect being to convert the earlier accrual into a "provisional or interim credit."⁸⁵ It reasoned as follows:

. . . the law having directed the adjustment of the amount accrued to the amount actually paid, the necessary inference is that the amount of the payment if made in . . . [foreign] money shall be converted into American money at the rate of exchange *as of the date of payment*, since this is the only way of arriving at the amount actually paid. To convert a payment made in . . . [a subsequent year] into American dollars at the rate of exchange prevailing . . . [in the earlier year of accrual] would be to allow the taxpayer a greater or less amount than he has actually paid, depending upon whether the rate of exchange . . . [in the earlier year] is higher or lower than that in . . . [the later year].⁸⁶

The foregoing principles, initially established by rulings, were approved shortly thereafter by the Board of Tax Appeals.⁸⁷

In 1924, a congressional committee called attention to the fact that many foreign countries, like our own, provided for the payment of income taxes during the year following the year for which the tax was imposed.⁸⁸ This meant that cash basis taxpayers were taking a credit against the domestic tax in the year following the year in which their foreign income was earned. To avoid any prejudice which might result as a consequence of variation in the yearly amount of foreign income, the statutory provision regarding the credit was amended at the committee's request so as to permit cash basis taxpayers to elect to reflect the credit in the same manner as accrual taxpayers.⁸⁹

⁸³ Revenue Act of 1913, § 238(a).

⁸⁴ I.R.C., § 905(c).

⁸⁵ Texas Company (Caribbean) Ltd., 12 T.C. 925, 929 (1949), Acq., C.B. 1949-2, 3.

⁸⁶ S.M. 4081, C.B. IV-2, 201 at 202 (1925). (Italics added.)

⁸⁷ D. E. Brown, 1 B.T.A. 446 (1925); Mead Cycle Co., 10 B.T.A. 887 (1928), Acq., C.B. VII-2, 26. Also, Texas Company (Caribbean) Ltd., 12 T.C. 925 (1949), Acq., C.B. 1949-2, 3.

⁸⁸ H. Rep. No. 179, 68th Cong., 1st Sess. 22 (1924).

⁸⁹ Revenue Act of 1924, §§ 238(c) and 222(c), now I.R.C., § 905(a).

The special character of the provisions relating to accrual of foreign taxes for purposes of the credit has led to modification of one other doctrine which applies to accrual of domestic taxes.

In the latter circumstance, an accrual basis taxpayer must postpone accrual of any tax, liability for which he is contesting. The accrual takes place in and for the year the contest is settled.⁹⁰ While the accrual of that part of any foreign tax being contested must also be postponed until the matter is resolved, it has been held, and the Service agrees, that the congressional aims permitting accrual in a foreign tax setting justify relating the accrual back to the year for which credit would have been taken in the absence of the contest.⁹¹

Accrual basis taxpayers, as well as cash basis taxpayers who elect the accrual method, may be required to post a bond on accruing the credit prior to payment of the foreign tax.⁹² In both settings, a ten-year statutory period of limitations has also been imposed on recognition of *overpayments* of American tax resulting from subsequent redeterminations reflecting differences between the amount of foreign taxes accrued and that actually paid.⁹³

(c) *Conversion for purposes of the "deemed-paid" tax credit.*—As previously noted, an American corporation may enjoy a credit for a proper part of any foreign income taxes paid or deemed paid by a foreign corporation at least 10% of the voting stock of which is held by the domestic enterprise.⁹⁴ This credit may be taken, however, only as dividends are drawn from the foreign corporation. Thus the question may arise as to whether, for credit purposes, the amount of foreign taxes paid by the foreign corporation should be converted into American dollars according to the rate of exchange prevailing when the foreign corporation paid the foreign tax or according to a rate later prevailing when a dividend is included in the American corporation's gross income.

The first contested situation involved a dividend received from a foreign corporation's earnings and profits of an earlier year the foreign tax on which had been paid in the earlier year. The foreign

⁹⁰ *Dixie Pine Products v. Comm'r.*, 320 U.S. 516, 64 S. Ct. 364 (1944).

⁹¹ *Cuba Railroad Co. v. U.S.*, (D.C. S.D. N.Y. 1954) 124 F. Supp. 182; Rev. Rul. 58-55, C.B. 1958-1, 266.

⁹² I.R.C., § 905(c).

⁹³ I.R.C., § 6511(d)(3). If the foreign tax is refunded and the American credit is thereby reduced, interest will not be assessed by the American government with respect to the redetermination except to the extent interest was paid by the foreign country on the refund. I.R.C., § 905(c).

⁹⁴ I.R.C., § 902.

corporation had always kept its accounts in terms of the foreign currency with which it had also paid the foreign tax. The Board of Tax Appeals noted that prior to the declaration of the dividend, "neither the earnings nor the taxes of that foreign subsidiary had in any way affected the income tax liability of the domestic corporation."⁹⁵ Since, prior to the dividend, there had never been any occasion to reduce the payment of foreign taxes into American dollars, the Board, like the government, thought that it was "reasonable and logical" to effect the conversion according to exchange rates prevailing *at the time of the dividend*, rather than at the time the foreign tax was actually paid by the foreign corporation.⁹⁶

The government thought the same principle should apply even though the foreign corporation always kept its accounts in American dollars, using the latter to pay dividends and to purchase foreign currency with which to pay its foreign tax. But the Tax Court (formerly Board of Tax Appeals)⁹⁷ and the Court of Appeals for the Second Circuit⁹⁸ thought otherwise. In this circumstance, the exchange rate prevailing at the time of the dividend was thought to have no relation whatever to the amount of accumulated earnings and profits, to the dividend, or to the foreign taxes actually paid. The foreign corporation itself had invoked an exchange rate at the time it used its own American dollars to buy the foreign currency with which to pay the foreign tax. Accordingly, in this circumstance it was thought that no exchange problem arose at the time of the dividend. Subsequently, the government acquiesced in the distinction between the two cases.⁹⁹

⁹⁵ *Bon Ami Co.*, 39 B.T.A. 825, 827 (1939).

⁹⁶ *Id.* at 828.

⁹⁷ *American Metal Co.*, 19 T.C. 879 (1953).

⁹⁸ (2d Cir. 1955) 221 F.(2d) 134, cert. den., 350 U.S. 829, 76 S. Ct. 61 (1955).

⁹⁹ Non-acq. to the Tax Court's opinion, in C.B. 1953-1, 7, was withdrawn in C.B. 1955-2, 3.

PART V. FOREIGN AND AMERICAN TAXES ON
INDIVIDUALS AS THEY AFFECT MOVEMENT
OF EMPLOYEES TO FOREIGN LANDS

SECTION A. INTRODUCTION

American enterprises which create foreign subsidiaries or open permanent establishments in Common Market countries are likely to transfer certain of their American employees to the foreign stations. The country-by-country survey in PART I, *supra*, furnishes the background for the comparison in Section B, below, of the ways and extent to which income taxes of member nations will affect American citizens so assigned. Generally speaking, until such time as the American becomes a resident of a particular Common Market country as defined under its law, each nation will assert jurisdiction only over that income for which it is the source. When residence in a particular country is established pursuant to its law, that Common Market nation will generally increase its jurisdictional sweep to include the resident's income from *all* sources. But even in this circumstance, unilaterally and by treaty, most of those countries have provided some form of relief to mitigate double taxation with respect, at least, to certain types of income which the displaced American continues to derive from sources in the United States. In other words, to that extent, most of them acknowledge the priority of the United States over its own citizens. Moreover, unilaterally or under bilateral tax treaties between member nations, the foreign country of residence may also grant some relief with reference to any income which the American may derive from other member nations.

While the notion of gross income which prevails in the United States generally requires a citizen to include income "from all sources" though the item may also be subject to a foreign tax, there are circumstances in which Congress has permitted Americans stationed abroad to immunize foreign *service* income from the American tax. This concession is geared generally to establishment of bona fide residence in a particular foreign country but pursuant to standards fixed by American law. Alternatively, extended physical presence abroad, i.e., presence in one or more countries, for a

period approximating $1\frac{1}{2}$ years will warrant an exclusion, though here there is a limitation on the amount. To the extent of the immunity thus granted, the United States in effect acknowledges the sole right of the foreign country or countries to tax any "earned" income which has its source there. The discussion of this matter in Section C, below, is coupled with an analysis of the way in which the foreign tax would be integrated with the American tax in the instance where the immunizing criteria specified by Congress are not satisfied.

Other employees who are permanently stationed at the home office in the States may be called upon to make more or less brief business trips to the scene of the foreign operation. Alternatively, Americans who have been stationed abroad might be called back to the States for a short time. Nonresident alien employees, i.e., citizens of Common Market countries, might also be brought from their overseas stations to the home office for consultation, etc. Within the same taxable year, any one of these three classes might perform services at home as well as in a foreign land. This could complicate their tax problems, for the Code as well as bilateral treaties generally look to the place where service is performed, rather than to the place of payment, in fixing the *source* of compensation for tax purposes. And source itself is generally considered the prime basis for asserting jurisdiction over compensation. However, Section D, below, calls attention to a standard which has been added to the Internal Revenue Code, and to others incorporated in treaties, for the purpose of freeing certain international business visits from such tax complications. The device involves a modification in the rules which generally designate the place of service as the source of earned income. Subject to certain conditions, each country in effect foregoes treating itself as the source of compensation even though the business visitor actually performed services there. But this variation is only applied by each country to those business visitors who are *nonresident aliens*, and then only if such persons are physically present for a period usually not exceeding 6 months. In other words, the United States would not forego taxability of income attributable to services performed *in the States* by a business visitor who is an American citizen, and this is so though he might then actually be a resident of a foreign country.

SECTION B. COMPARING COMMON MARKET TAXES ON AMERICANS ASSIGNED TO WORK IN A MEMBER NATION

(a) *Foreign tax effect when an American establishes residence abroad: In general.*—Aside from special exclusions designed to accommodate international business visits, the income tax of almost all countries reaches earnings derived by anyone from personal services performed locally. Common Market countries, like the United States, go on generally, however, to consider *residence* there a proper basis for asserting jurisdiction over a person's *total* income, from wherever derived. Absent special provision, this would mean that at least two countries would be asserting worldwide jurisdiction over the total income of an American citizen who has taken up residence in a Common Market country. Section C, *infra*, describes the two prime types of relief which have been incorporated into the Internal Revenue Code to accommodate the plight of such a person. The first, in the form of an inclusion, is limited to the American citizen's foreign *service* income. The second, in the form of a credit for any foreign income tax which may have been paid, would, *inter alia*, accommodate that citizen's other income but only to the extent it is derived from sources *outside* the United States. In other words, America insists upon *full* payment of tax attributable to that part of a nonresident citizen's income which may have been derived from sources *within* the United States. Many foreign countries have unilateral statutory provisions which are designed, in one degree or another, to protect any resident who is an American citizen from double taxation with respect to this latter type of income. Luxembourg has one of the least attractive arrangements of this type in that it only allows the American tax attributable to such benefits to be deducted from gross income in computing the net base. The other five Common Market countries are now hemmed in by provisions in the bilateral tax treaties. As is indicated more fully in the notes,¹ these fall into three general categories. The Bel-

¹ By Article XII of the Belgian treaty, Belgium agreed (1) to reduce to 1/5th the Professionnelle and Nationale Crisis taxes which would otherwise be levied on income sourced in and taxed by the United States, (2) to tax income from personal and real property having a source in the United States at a maximum rate of 12%, and (3) to reduce to 1/4 the personal complementary tax on the American citizen with reference to income sourced in and taxed by the United States.

Unilaterally, Italy does not apply its complementary progressive income tax on a resident alien's income from other sources until it is remitted. But by Article XV(1) (b)

gian provision calls for a substantial reduction in the rate on that income which such a person continues to derive from American sources. Italy responds by crediting the American tax against their own assessments. Germany, France, and the Netherlands, on the other hand, generally provide exemptions for such income though the latter country does not grant such in the case of dividends, interest, and royalties received by individuals.

The Common Market countries also take different approaches in resolving the question of whether an American has become a resident in one of the former countries for tax purposes. A person who has resided in Germany or in Luxembourg for a period in excess of 6 months is deemed a resident and will be taxed accordingly, beginning with the first day of his stay. While the basic period in France is five years, a person in the service of an enterprise situated there is likely to be considered a resident after one year and be taxed accordingly from that moment on. At a minimum, he will be taxed the first year on income having its source in France or on a sum equal to five times the rental value of his house or apartment, whichever is greater.

Theoretically, the other three member nations do not gear the question of residence for tax purposes to any particular period of stay. Under the taxing statutes of Belgium and the Netherlands, the question turns on the total facts. In Italy the matter is tied to the civil law interpretation of domicile. But as a practical matter, all three countries will normally assert residence at least at the point when a stay has extended beyond one year.

of the treaty, Italy agreed to reduce its tax by the amount of United States tax on income from sources in the United States where such income was not exempt from United States tax. The formula includes an arrangement to prevent the credit from immunizing Italian taxes on income derived from non-United States sources. Dividends sourced within the United States are treated separately; Italy allows a credit against tax in an amount equal to 8% of the dividend itself.

By Article XIX(3) of the Netherlands treaty, the Netherlands agreed to grant a credit, insofar as allowed by Netherlands law, for income taxes paid to the United States. But see also the reference in Section D, *infra*, to an exclusion permitted by the national law of the Netherlands.

By Article XV(1)(b) of the German treaty, Germany agreed to immunize from tax income of an American citizen derived from the United States and not exempt from United States tax. However, Germany reserved the right to include excluded items for the purpose of determining the rate applicable to other income.

Article 14(B) of the French treaty governs its response. A credit is allowed against the proportional tax on interest, dividends, and trust income, derived from the United States. Any other income derived from the United States is exempt from that tax. Also, Article 164 of the French General Tax Code has been frozen into the treaty, and generally exempts U.S. income from the French general income tax when derived by an American residing in France, providing such income was taxable in the United States.

(b) *Comparative progressive impact of Common Market income taxes on employment income.*—The country-by-country survey in PART I contained separate descriptions of the income taxes which each member nation would impose on individuals. Three countries—Germany, Luxembourg, and the Netherlands—follow a basic pattern much like that used in the United States in that only one income tax is imposed on individuals. France's reform in late 1959 also moved it toward that same type of structure. While at least temporarily it did retain a complementary tax in addition to its general income tax, only the latter applies to wages and salaries. In lieu of the former, employers pay a substitute tax which the employees may credit against their general income tax.

The two other countries—Belgium and Italy—superimpose a progressive surtax on other separately scheduled income taxes which are divided by reference to various classes of income.

Considerable variation also exists with reference to the way in which allowances for a spouse and other dependents are handled. The Italian approach to this problem most closely resembles that of the United States; the matter is accommodated by deductions from gross income in arriving at the tax base. The personal allowance for the taxpayer amounts to \$387; each dependent, including a spouse, gives rise to an additional \$81 deduction.

Belgium solves the dependency problem through credits against tax on the first \$5,000 of income, as follows:

- (a) 5% each for the first and second dependents;
- (b) 10% each for the third and fourth dependents; and
- (c) 20% for each additional dependent.

Belgium also exempts from tax a modest amount (\$500 to \$800 depending on the size of municipality in which the taxpayer resides) but only if the total income does not exceed the exemption.

The French response involves a split-income arrangement for computation purposes, the taxpayer and his spouse counting as one each, other dependents being counted as $\frac{1}{2}$ each.

Germany also mitigates progression by allowing the taxpayer to split his income with his spouse for computation purposes. Allowances for children, however, are handled in a fashion similar to that in the United States and Italy, the deductions from gross income being \$214 for the first child, \$400 for the second, with \$428 being allowed for each additional child.

Finally, Luxembourg and the Netherlands approach the prob-

lem through multiple rate tables, the choice of a particular table being dependent upon the taxpayer's family situation.

As indicated in PART I, other deductions from an individual's gross income will also vary from country to country. However, practically all have established some kind of minimum standard deduction to accommodate an employee's *business* expenses; amounts in excess of that must be itemized *en toto*. Also interesting because of its departure from American practice is the allowance frequently allowed for life insurance premiums, up to a certain amount. Germany and Luxembourg add on old age, health, and accident insurance. While Belgium also allows a deduction for social security contributions, the Netherlands even permit a deduction up to a certain amount for premiums paid on a life annuity contract. Life insurance, however, is not accommodated there. Germany and Luxembourg also permit a taxpayer to take a standard personal deduction in lieu of itemizing most other personal deductions. This is separate and apart from the standard business deduction previously mentioned.

A final significant departure from American practice involves a deduction of all or a part of the income tax itself. While France and Italy permit their complementary tax and separately scheduled income taxes, respectively, to be deducted from the amount subject to their respective progressive taxes, Belgium goes on to allow the progressive tax of one year to be deducted from that income subject to progressive tax in the next year.

Comparison of the relative impact of each member nation's income tax on individuals is only possible on the basis of assumed facts. Table V A assumes that all income (salaries of \$6,000, \$12,000, and \$48,000) was derived from employment, and reflects the *effective* percentage which would be absorbed by taxes against single taxpayers and married taxpayers with two children, standard minimum deductions also having been taken into account. It will be noted that Italy is quite generally on the low side, with the Netherlands being consistently on the high side. Also to be noted is the fact that the United States would generally fall into the less demanding group, for real progression in Europe generally starts at a lower figure than in the United States.

Many Americans will draw an added bonus from their employers for foreign service even though the dollar has a comparatively high purchasing power in most Common Market countries. Foreign tax

TABLE V A
EFFECTIVE RATES ON SALARY INCOME

COUNTRY	Salary, \$6,000		Salary, \$12,000		Salary, \$48,000	
	Single Taxpayer	Married and Two Children	Single Taxpayer	Married and Two Children	Single Taxpayer	Married and Two Children
Belgium	22.37%	16.77%	36.61%	34.23%	56.70%	56.10%
France *	22.33%	8.19%	28.42%	14.98%	41.97%	31.22%
Germany **	*** 25.2 %	16.—%	*** 33.5 %	24.3 %	*** 47.2 %	40.80%
Italy	12.36%	12.05%	14.98%	14.84%	21.74%	21.60%
Luxembourg	28.53%	13.88%	39.65%	27.50%	51.55%	49.06%
Netherlands	36.21%	28.35%	49.07%	40.36%	64.30%	61.11%
United States	17.40%	10.—%	24.20%	15.40%	50.50%	35.60%

* In comparing the French effective rate, account must be taken of the fact that salaries are free from the 8% complementary tax, employers paying in lieu thereof a slightly progressive tax by reference to wages paid each employee. Though paid by the employer, this latter tax is credited by the employee against his general income tax. The above figures take into account a 5% credit, this being the normal percentage paid by employers.

** A church tax, usually amounting to 8% of the tax on wages, must be added.

*** Figures are those applicable to taxpayers under age 50.

authorities generally treat this as part of their taxable incomes. Americans do, however, frequently receive quite favorable treatment on other scores; this varies from special allowances for expenses up to a certain percentage, to acceptance of currency exchange rates which are lower than those officially posted. Illustratively, where American controlled enterprises have sent employees from the head office to establish Belgian factories or offices, those employees who are deemed to retain their tax residence in the United States have received the benefit of a special ruling from the Belgian authorities. If the employee's European activities are conducted almost exclusively in Belgium, he is permitted a standard deduction equal to 50% of the salary received in Belgium.

Generalizations with respect to the circumstances in which Americans may enjoy special tax benefits are not really meaningful, however, for such matters usually depend upon negotiation in each case. And as more and more Americans take up residence in the Common Market, it is likely to become more difficult to obtain such privileges.

SECTION C. IMPACT OF U.S. INCOME TAX ON AMERICAN EMPLOYEES ASSIGNED TO FOREIGN STATIONS

(a) *Introductory note.*—In the first income tax act passed pursuant to the Sixteenth Amendment, Congress asserted a power to tax an American citizen on his income “from all sources,” without regard to whether he worked or resided “at home or abroad.”² This sweeping view of jurisdictional power was sustained—as a constitutional matter—on the theory that “government, by its very nature benefits the citizen and his property wherever found. . . .”³ It was equally true, however, that a citizen who derived his income by performing services in a foreign country also benefitted from the activities of that government and, at least to the extent of the income earned there, was usually taxed by it.⁴ Congress began to respond to this double tax threat in 1916; within 10 years, it had instituted three relief measures. These served as mutually exclusive alternatives in some situations; in certain others they were complementary.

The first congressionally inspired relief against double taxation has survived in slightly altered form to this day. It involves a deduction from gross income of most of the different types of taxes imposed by a foreign country.⁵ But this deduction fell far short of relieving the citizen of the *entire* burden of his foreign tax. For example, if his effective domestic rate was 33%, the American tax was in effect reduced only by an amount equal to one-third of the foreign tax. The taxpayer himself continued to shoulder the economic burden of the remaining two-thirds.

The consequence of this limited form of relief was re-examined during World War I when both domestic and foreign income tax rates were being increased. Fear was expressed that citizens were still discouraged “from going out after commerce and business in different countries or residing for such purposes in different countries.” It was asserted that some would even “become a citizen of another country . . . in order to escape the large and double taxa-

² Rev. Act of 1913, Section II, § A, Subdiv. 1.

³ *Cook v. Tait*, 265 U.S. 47, 56, 44 S. Ct. 444 (1924).

⁴ The prime exception to this rule of taxability today relates to immunity accorded nonresident alien business visitors whose performance of services and stay do not exceed a limited period, usually 6 months. See discussion in Section D, *infra*.

⁵ Rev. Act of 1916, § 5(a) Third, now reflected in I.R.C., § 164. The deduction does not embrace estate, inheritance, legacy, succession, or gift taxes, nor taxes assessed against local benefits of a kind tending to increase the value of the property assessed.

tion imposed.”⁶ As an alternative to the deduction, it was provided that foreign *income* taxes, as well as war profits and excess profits taxes, could be taken as a *credit* against the American tax itself.⁷ The previously existing deduction arrangement now assumed a complementary as well as an alternative status. It complemented the credit in that it was the only form of relief with regard to foreign taxes other than income taxes, though later the *credit* itself was extended to cover *any* foreign tax paid “*in lieu of a tax on income, war profits, or excess profits otherwise generally imposed*” by a foreign country.⁸

From the earlier discussion in Section B, *supra*, it will be recalled that the effective income tax rates in several Common Market countries exceed those assessed in the United States. If a taxpayer's entire income is attributable to his foreign employment, the effect in this circumstance would be to wipe out his American tax liability. The taxpayer may not avail himself, however, of any excess foreign tax as an offset against any American tax liability attributable to income which he derived in that year from United States sources. More accurately speaking, one's credit for income taxes paid a foreign country may not exceed that proportion of the American tax which his “taxable income” from the foreign country bears to his total “taxable income.”⁹

The comparisons made in Section B, *supra*, also revealed in some circumstances that the effective American rates were higher than those of some Common Market countries, Italy being the most striking example. American emphasis on the income tax was even more noticeable when compared to many non-European countries. In the mid-1920's, this meant that any differential in tax was always paid over to the federal government. In that era, however, an asserted desire to help increase our exports led the House Committee on Ways and Means to propose that under certain conditions

⁶ Statement of Representative Kitchen, 56 Cong. Rec. 677-678 (1918).

⁷ Rev. Act of 1918, § 222(a)(1), now, as modified, I.R.C., § 901 et seq.

⁸ Rev. Act of 1942, § 158(f), amending I.R.C. (1939), § 131, now I.R.C. (1954), § 903. (Italics added.)

⁹ I.R.C., § 904. For the purpose of computing this limitation, an individual's “taxable income” must be computed without any deduction for personal exemptions. Provision is made in § 904 for a carry-over of excess foreign taxes, but this will usually be advantageous only if the foreign rate is reduced in future years to a point below the American rate. For other details relating to the credit, see PART III, *supra*. Section F of that Part calls attention to the new statutory election which permits the taxpayer to substitute an “overall” limitation for the per-country limitation discussed in the text. In effect this would permit the taxpayer to average foreign taxes paid to high- and low-tax countries.

Americans working abroad in connection with export sales be freed of any such differential with regard to their salaries or commissions. An *exclusion* of such benefits from their domestic gross income was to serve as the device by which to accomplish this end.¹⁰ While the Senate agreed that certain conditions should be imposed, it insisted that this third more favorable and controversial arrangement be extended to *all* types of foreign *earned* income.

This latter exclusion was to be the repeated focus of congressional concern for many years. Only where its constantly changing requirements could not be satisfied would a citizen assigned to a foreign station normally fall back on the *credit* for foreign income taxes and the *deduction* for other foreign taxes.

While the exclusionary device would obviously be most advantageous where the service was performed in a low income tax country like Italy, it must be remembered that the advantage would be diluted in some part by the prejudice which such a citizen would otherwise suffer because of the substantial reliance by low income tax countries on turnover taxes. The latter, normally not considered income taxes nor imposed in lieu of such, would not usually qualify for the credit.¹¹ Nor would they qualify for the alternative deduction to the extent such taxes were imposed on persons other than the ultimate consumer, and this was so though in the end the economic, as distinguished from the legal, incidence of such taxes fell on the consumer.¹²

A discussion of the shifting statutory standards applicable to the exclusion for foreign service income follows.

(b) *Evolution of the present alternative standards applicable to the exclusion.*—The House first proposed that the exclusion for foreign service income be allowed if the citizen was abroad for more than 6 months of the taxable year.¹³ This dividing line was seized upon because certain countries subjected an American to their income tax if he lived there in excess of 6 months.¹⁴

While the Senate Finance Committee thought it was enough in such cases to grant the previously allowed credit for foreign income taxes,¹⁵ in the end the exclusionary principle prevailed, but only if

¹⁰ H.R. 1, 69th Cong., 1st. Sess. 7 (1926), § 213(b) (14) of Committee Print No. 1.

¹¹ See *e.g.*, Rev. Rul. 56-635, C.B. 1956-2, 501.

¹² The provision in I.R.C., § 164, which authorizes consumers to deduct retail sales taxes which are actually imposed on retail vendors, does not even apply in a foreign setting.

¹³ See note 10, *supra*.

¹⁴ Statement of Senator Reed, 75 Cong. Rec. 10410-11 (1932).

¹⁵ S. Rep. No. 52, 69th Cong., 1st Sess. 20-21 (1926).

the citizen was a "bona fide *nonresident* of the United States for more than *six months* during the taxable year."¹⁶

The latter condition, interpreted to require nothing more than *physical absence* from the United States for over half of the taxable year,¹⁷ was later thought in practice to be entirely too lax. Within 4 years, the Senate Committee discovered "to our surprise, that . . . American ambassadors and ministers and officers of the foreign service were getting clear out of the payment of any income tax . . . , which nobody in the world ever intended. . . . These people do not deserve the exemption, because they are not subject to the income taxation of the foreign countries in which they are stationed. . . ." ¹⁸ Of course, this could be, and was, remedied by neutralizing the exclusion in the case of amounts paid by the United States or any agency thereof.¹⁹ But in 1942, the same Committee noted that the provision had also "suffered considerable abuse in the case of [other] persons absenting themselves from the United States for more than 6 months simply for tax-evasion purposes."²⁰ There was no guarantee, of course, that such a person would stay in one foreign country long enough to suffer its tax. This, plus the asserted belief that the whole idea of an exclusion involved "unjust discrimination" in favor of those earning income abroad, led the House Committee on Ways and Means—the original sponsors of the exclusionary principle—to call for its complete elimination.²¹ But the Senate Committee thought such an elimination would "work a hardship in the case of citizens . . . who are bona fide residents of foreign countries," noting, for example, that "many employees of American business in South America do not return to the United States for periods of years. Such persons are fully subject to the income tax of the foreign country of their residence."²² In the end, the Senate prevailed; the exclusion was still to be allowed, but only if the person was a (1) "*bona fide resident* of a foreign country or

¹⁶ Rev. Act of 1926, § 213 (b) (14). See also H. Rep. No. 356, 69th Cong., 1st Sess. 367 (1926) for conference amendments.

¹⁷ G.C.M. 9848, C.B. X-2, 178. This view was also adopted in *Commissioner v. Fiske*, (7th Cir. 1942) 128 Fed. (2d) 487, cert. den., 317 U.S. 635, 63 S. Ct. 63 (1942).

¹⁸ Statement of Senator Reed, 75 Cong. Rec. 10410-11 (1932).

¹⁹ Rev. Act of 1932, § 116 (a), now reflected in I.R.C., § 911. However, certain immunities are provided in the case of cost of living allowances drawn by certain government employees. I.R.C., § 912. Post World War II treaties with Common Market countries provide immunity from foreign tax in the case of amounts paid by the United States or its agencies.

²⁰ S. Rep. No. 1631, 77th Cong., 2d Sess. 54 (1942).

²¹ H. Rep. No. 2333, 77th Cong., 2d Sess. 50 (1942).

²² S. Rep. No. 1631, 77th Cong., 2d Sess. 54 (1942).

countries" and (2) was such "during the *entire* taxable year."²³

The intended effect of this shift, according to the Chairman of the Senate committee, was to reach those "American citizens who are merely *temporarily* away from home," while preserving the exclusion "in the case of the bona fide, nonresident American citizen who *established a home* and maintains his establishment and *is taking on the corresponding obligations of the home* in any foreign country. . . ." ²⁴

To accommodate the problem which would arise under the "entire-taxable-year" rule in the case of mid-year changes of residence back to the United States, it was further provided that if the person had been a bona fide resident of a foreign country for at least a two-year period before he again took up residence in the United States, earned income attributable to the *final* partial year was excludable.²⁵

Almost a decade passed without further change. Then, in 1951, the Senate Finance Committee moved to liberalize the exclusion on two fronts.

To alleviate the first-year plight of one who became a bona fide resident of a foreign country in mid-year, the "*entire-taxable-year*" rule was modified so as to allow the exclusion where such residence was "for an uninterrupted period which includes an entire taxable year."²⁶ Even more important was the establishment over the House Committee's objections of a general standard which continues to serve today as an alternative to the bona-fide-residence rule. This separate test involved a revival in modified form of the earlier discarded and less demanding *physical absence* test.

In developing this alternative, the Senate Committee noted that the United States was then trying to aid foreign countries under the Point 4 foreign aid program, and that in keeping with this program it was desirable "to encourage men with technical knowledge to go abroad."²⁷ It was further asserted that because "the term 'bona fide' residence abroad . . . [had] been construed quite strictly," many persons who had gone abroad to work "even for a relatively

²³ Rev. Act of 1942, § 148(a), amending I.R.C. (1939), § 116(a).

²⁴ Hearings, Senate Finance Committee, H.R. 7378, 77th Cong., 2d Sess., Vol. I, 743 (1942). (Italics supplied.)

²⁵ Rev. Act of 1942, § 148, amending I.R.C. (1939), § 116(a). While the language of the provision might not seem to limit the exclusion to income for the last partial year, the committee's report and the catchline in the statute indicated this was the limited purpose. S. Rep. No. 1631, 77th Cong., 2d Sess. 55 (1942).

²⁶ Rev. Act of 1951, § 321(a), amending I.R.C. (1939), § 116(a), now reflected in I.R.C., § 911(a)(1).

²⁷ S. Rep. No. 781, 82d Cong., 1st Sess. 53 (1951).

long period of time" had been unable to obtain an exclusion of their foreign earned income.²⁸ They had failed to measure up on either of two counts.

One difficulty was that the "nature of the individual's work . . . [was] such as to make it difficult to establish a 'residence' in the more widely accepted use of the term."²⁹ Others had fallen short because they had "gone abroad only for a stated period of time. Examples of this . . . [were] managers, technicians, and skilled workmen who are induced to go abroad for periods of 18 to 36 months to complete specific projects."³⁰

The enacted solution granted an exclusion of foreign earned income where the person was physically present in a foreign country or countries 510 days (approximately 17 months) out of any *consecutive* 18 month's period, though for reasons previously stated in connection with the bona-fide-residence test, this immunity was not to be available with regard to amounts received from the United States government or an agency thereof.³¹

Within two years, widely publicized abuses of the new alternative standard which had been added to what is now § 911 of the Code led the House Committee, in 1953, to respond to the Secretary of the Treasury's demand for "corrective legislation"³² by calling for complete elimination of the new alternative. Both noted that while the provision "was designed to encourage men with technical knowledge to go abroad in order to complete specific projects, . . . individuals with large earnings [such as movie stars] have seized upon the provision as an inducement to go abroad to perform services, which were customarily performed at home, for the primary purpose of avoiding the Federal income tax."³³ Equally disturbing was the fact that in many such cases, the persons did "not pay income tax even to the foreign country or countries in which the income is earned. This is because they are not in any particular foreign country long enough to establish a residence or because the foreign country in question does not impose any income tax."³⁴

²⁸ *Ibid.*

²⁹ *Ibid.*

³⁰ *Ibid.*

³¹ Rev. Act of 1951, § 321(a), amending I.R.C. (1939), § 116(a)(2), now found in altered form in I.R.C., § 911(a)(2).

³² Ltr. to Chairman of the House Committee, dated April 13, 1953, 99 Cong. Rec. 3079 (1953).

³³ H. Rep. No. 894, 83d Cong., 1st Sess. 4-5 (1953).

³⁴ *Ibid.*

In the end, a less drastic change proposed by the Senate prevailed; it was content to limit the exclusion under this alternative standard to \$20,000 per taxable year, or to a pro tanto part thereof for any period less than a taxable year.³⁵ This limitation, did *not*, however, carry over to those persons who could satisfy the older and quite separate bona-fide-residence test.

(c) *Differences in the character of foreign status required by the exclusionary principle's two alternative standards.*—More handsomely paid Americans who are assigned to work in a Common Market country, particularly in one which has a low income tax such as Italy, will derive greater advantage if they satisfy § 911's foreign-bona-fide-residence test rather than its alternative 510-day rule. Satisfaction of the former would permit avoidance of the latter's \$20,000 per year limitation. As we shall later see, even in the case of those less well paid, the bona-fide-residence test will also more effectively preserve the integrity of the exclusion with reference to certain deferred compensation plans, and will facilitate more flexible planning with respect to vacations and business trips back to the States. Except in the most clear cut cases, however, it has not been easy to predict in advance whether the more liberal bona-fide-residence test will be satisfied.

Little interpretative difficulty will be encountered, of course, in connection with the one mathematically fixed objective criterion to the effect that a qualified status must exist "for an uninterrupted period which includes an *entire taxable year*." But in addition to this independent requirement relating to time, a *qualified* status, i.e., something more than mere physical presence in a foreign country, must also exist. Difficulty in predicting whether one has become a bona fide resident of a foreign country under *American* standards stems from the fact that it turns on "his *intention* with regard to the *length* and *nature* of his stay."³⁶ And here one starts with two handicaps. As one court put the first, "Exemptions as well as deductions are matters of legislative grace, and a taxpayer seeking either must show that he comes squarely within the term of the law conferring the benefit sought."³⁷ Even if the facts are stipulated, there will be difficulty in showing that they "squarely" satisfy a rule so ill-defined.

³⁵ S. Rep. No. 685, 83d Cong., 1st Sess. 5 (1953). Technical Changes Act of 1953, § 204(a), amending I.R.C. (1939), § 116(a), now I.R.C., § 911(a)(2).

³⁶ I.T. Regs., § 1.911-1(a)(2) refers back to § 1.871-2(b) for this definition. (Italics added.)

³⁷ Donald H. Nelson, 30 T.C. 1151 (1958).

Second, frequently the question is said ultimately to be one of fact with regard to which the taxpayer bears the burden of proof.³⁸ And because it is a question of fact, Tax Court decisions, to which one might otherwise look for authority, generally include a statement in the "Findings of Fact" to the effect that the particular taxpayers involved there were or were not bona fide residents of a foreign country.³⁹ In most cases, however, those persons intended to do just what they did do, and the standard to which the intention must relate was at least closely akin to a question of law. Courts implicitly recognized this when they made an effort in their opinions to distinguish the cases at bar from other decisions.⁴⁰ But even when doing this, they frequently added, because *all* surrounding circumstances were important in deciding such cases, that it was not possible or worthwhile to attempt to harmonize the many decisions.⁴¹

Certainly there is general agreement that cases involving questions of residence in *non-tax* statutory settings are of no value;⁴² "bona fide residence" for this purpose is to be determined in the light of the congressional purpose in enacting this particular provision.

In seeking out the congressional purpose, the report of the sponsoring Committee furnished two helpful guides, one of which had only a narrow thrust. It was to the effect that "Vacation or business trips to the United States during the taxable year will not necessarily deprive a taxpayer, otherwise qualified, of the exemption provided by this section."⁴³ The other was to the effect that American tests used in determining whether an alien was a resident of the States were to be employed in deciding whether an American was a bona fide resident of a foreign country.⁴⁴ This led courts to place great reliance on the previously existing regulations relating to aliens, and these administrative provisions turned the question on the taxpayer's intention "with regard to the length and nature of his stay."⁴⁵

In general, those regulations sought to distinguish *transients* from those who truly made their "home" abroad. With reference to

³⁸ *Ibid.*; Leonard Larsen, 23 T.C. 599 (1955).

³⁹ Burlin B. Hamer, 22 T.C. 343 (1954); Charles F. Bouldin, 8 T.C. 959 (1947).

⁴⁰ Fred H. Pierce, 22 T.C. 493 (1954); Charles F. Bouldin, 8 T.C. 959 (1947).

⁴¹ Leonard Larsen, 23 T.C. 599 (1955).

⁴² Arthur J. H. Johnson, 7 T.C. 1040 (1946).

⁴³ S. Rep. No. 1631, 77th Cong., 2d Sess. 116 (1942); Seeley v. Comm'r., (2d Cir. 1951) 186 F.(2d) 541; I.T. Regs., § 1.911-1(a)(2).

⁴⁴ *Ibid.*

⁴⁵ Now in I.T. Regs., § 1.871-2(b). Henningsen v. Comm'r., (4th Cir. 1957) 243 F.(2d) 954; David E. Rose, 16 T.C. 232 (1951); Charles F. Bouldin, 8 T.C. 959 (1947).

the projected length of stay, the taxpayer would not fall short merely because he had a "floating intention, indefinite as to time, to return" to the States. But he could not attain the necessary status if, on going abroad, the purpose was one "which in its nature may be *promptly accomplished*." In other words, his purpose had to be of such a nature that "an *extended* stay may be necessary for its accomplishment, *and* to that end the . . . [person] makes his *home*. . . ." abroad. This was sufficient even though the person also intended "at all times to return to his domicile [here] . . . when the purpose" had been consummated or abandoned.⁴⁶

Obviously the difference between a purpose which may be "promptly accomplished" and one which requires an "extended stay" is not easily drawn. But in interpreting the further requirement that the person make his "home" in the foreign country, though he may ultimately intend to return, some courts have been assisted by the statement which the Chairman of the sponsoring Committee made during the course of congressional hearings. He said, it will be recalled, that the provision was intended to accommodate "nonresident American citizens who established a home and maintains his establishment and is taking on corresponding obligations of the home in any foreign country. . . ." ⁴⁷

It seems fairly clear from the foregoing that one might be able to predict that there would be a meaningful difference between the employee who lives abroad in company barracks, eats in a mess hall provided by the employer—mingling only with other employees,⁴⁸ and another who resigns from all of his American clubs, gives up his house in the States—moving his family and furniture abroad where he takes a long-term lease on a house, opens charge accounts, and joins in some community activities of the foreign country and pays income tax to it.⁴⁹ The fact is, however, that there are no reliable rules of thumb. For example, the first man might have been a resident from the beginning if he had intended, for

⁴⁶ I.T. Regs., § 1.871-2(b), (Italics added.) The cases agree that the person may be a foreign resident though the United States remains his domicile. *Comm'r. v. Swent*, (4th Cir. 1946) 155 F.(2d) 513; *Fred H. Pierce*, 22 T.C. 493 (1954). In *Leigh White*, 22 T.C. 585 (1954), the Court stated (at 590): "It is made clear by many decisions that the term is not to be confused with 'domicile,' and that it includes a temporary residence, where an extended stay is contemplated although there is at all times an intention thereafter to return to a former residence or to establish a new residence elsewhere."

⁴⁷ Hearings, Senate Finance Committee, H. Res. 7378, 77th Cong., 2d Sess., Vol. I, 743 (1942).

⁴⁸ Cf. *Ernest R. Hertig*, 19 T.C. 109 (1952).

⁴⁹ Cf. *David E. Rose*, 16 T.C. 232 (1951); *Herman F. Baehre*, 15 T.C. 236 (1950).

example, to bring his family over when housing became available.⁵⁰ And he may not have paid a foreign income tax only because he supposed, in his ignorance, that none was due because of something he had heard about tax treaties.⁵¹

To assure somewhat greater certainty of result, the taxpayer may also seek to qualify under the 510-days-out-of-18-months-foreign-physical-presence test, even though it is limited by the apportionable \$20,000 per year limitation.

The 510-day requirement relates to full days (midnight to midnight)⁵² actually spent in a foreign country.⁵³ It also includes the time spent in going between *foreign* countries so long as travel over international waters does not exceed 24 hours nor involve a detour to the United States, its possessions, or territories.⁵⁴ While the 510 days need not be consecutive, being broken by a vacation or business trips back to the States, the foreign earned income attributable to a particular day is immune only if that full day is one of 510 which do fall in a *consecutive* 18-month's period. Because of the peculiar way in which a taxpayer's interim return trips are scattered, in immunizing the income of a particular day, he may find it necessary to overlap different 18-month's periods, treating one as beginning before another ends.⁵⁵

(d) *Types of benefits excluded under § 911's alternative standards, and allocable deductions.*—A taxpayer who is entitled to a § 911 exclusion with respect to foreign service income may also avail himself of other exclusions applicable to taxpayers generally. For example, suppose that an American employer either pays or reimburses an old employee for expenses incurred by him in moving

⁵⁰ Cf. *Seeley v. Comm'r.*, (2d Cir. 1951) 186 F.(2d) 541; *Fred H. Pierce*, 22 T.C. 493 (1954).

⁵¹ Cf. *Charles F. Bouldin*, 8 T.C. 959 (1947). Also, *David E. Rose*, 16 T.C. 232 (1951); *White v. Hofferbert*, (D.C. Md. 1950) 88 F. Supp. 457. See *Ernest R. Hertig*, 19 T.C. 109 (1952).

⁵² I.T. Regs., § 1.911-1(b)(10).

⁵³ Defined to include only territory under the sovereignty of a foreign government and the air space above. I.T. Regs., § 1.911-1(b)(7).

⁵⁴ I.T. Regs., § 1.911-1(b)(10). If he does detour to the United States, its possessions, or territories, the period of the detour, including the day he left the foreign country through the day on which he returned to a foreign country, would not be counted in the 510 days.

⁵⁵ For example, assume that the taxpayer first arrived in France, from the United States, at noon, December 31, 1956. He left France for the United States at noon, December 1, 1957, arriving back in France on December 31, 1957. He again left France on August 1, 1958, returning there on August 31, 1958. He left France permanently for reassignment to the United States on July 1, 1959. Income attributable to March 15, 1957 would qualify by reference to the 18-month period, January 1, 1957 through June 30, 1958. Income earned on September 1, 1958 could qualify by reference to the overlapping period January 1, 1958 through June 30, 1959.

himself, his family, and furniture to an overseas station. This material benefit would not be covered by the § 911 exclusion. Practically all, if not all, of this benefit is attributable to a period prior to the establishment of foreign residence. Nor would the 510-day rule cover this arrangement, for its springs into operation only with the first full day in which the taxpayer is present in a foreign country. Nevertheless, the Internal Revenue Service agrees that this benefit would be excludable if the transfer was actually made for the convenience of the employer. In that circumstance, the payment is not deemed compensatory in character and is, therefore, beyond the reach of § 61 which defines gross income.⁵⁶

The § 911 exclusion itself constitutes a sanctuary from domestic tax only with reference to foreign "earned income"; other types of *foreign* income, such as interest or dividends, will enjoy only the advantage of the previously described credit or deduction allowed by American law for foreign taxes. None of these cushions will be available, however, with reference to any kind of income which has its source *in* the United States. This is so even with respect to income attributable to services performed during a temporary business visit to the United States by an American citizen who has become a bona fide resident of a Common Market country.⁵⁷

⁵⁶ Rev. Rul. 54-429, C.B. 1954-2, 53. The same ruling calls for a different result in certain situations involving *new* employees. Where an employee moves from one locality in the United States to another to accept employment with a new employer, reimbursement by the latter for those moving expenses would be includible in the employee's gross income and could not be deducted in arriving at taxable income. Also *U.S. v. Woodall*, (10th Cir. 1958) 255 F.(2d) 370, cert. den., 358 U.S. 824, 79 S. Ct. 39 (1958); Rev. Rul. 59-236, I.R.B. 1959-28, 14. Americans hired within the United States for re-assignment to foreign branches would normally spend a period at the home office, being oriented. Reimbursement for their subsequent oceanic travel would probably be excludable. But the result is less clear if a wholly owned foreign subsidiary paid oceanic moving expenses incurred by an old employee of the American parent on the occasion of his transfer from the parent's offices in the United States to the subsidiary's offices in the Common Market. Technically at least, the employee is changing employers.

⁵⁷ Looking only at the Code, it is clear that income from services has its source where the services are performed. I.R.C., § 861(a)(3). Moreover, the Code itself immunizes income from services performed in the States only in the case of certain nonresident *aliens* who are here for 90 days or less. *Ibid.*

The tax treaties which the United States has with 5 Common Market countries do not immunize the American earned income of a nonresident American. The treaty with Belgium is typical. On the one hand, it does provide that a "*resident* of Belgium shall be exempt from United States tax upon compensation for labor or personal services performed within the United States. . . ." if he fits certain classifications. Article XI. But in that treaty, as in the others, the United States reserved the right in the case of its own "*citizens* or residents or corporations . . ." to impose its regular income tax law as though the "convention had not come into effect." Article XII. Provisions similar to this have been interpreted to mean that the regular Code provisions apply to nonresident Americans. Marie G. Crerar, 26 T.C. 702 (1956).

The Code section which establishes an exclusion for foreign "earned income" goes on to relate it to "wages, salaries, or professional fees, and other amounts received as compensation for personal services actually rendered. . . ." ⁵⁸ In some settings, difficult questions of fact will arise in determining whether a given payment is truly for services or for something else. Illustrative are those situations where the taxpayer occupies a dual relationship to an enterprise, such as where he is an employee as well as a stockholder of a corporation or where he owns as well as manages a proprietorship with reference to which both capital and services constitute material income-producing factors. In the former setting, a principal stockholder—knowing that dividends would be includable in domestic gross income—may attempt to characterize a payment as compensation for his foreign services though the amount actually exceeds a reasonable allowance for these services. The government has the authority, of course, to police the provision, apportioning the excess to the dividend category. ⁵⁹ And in the case of the proprietorship where capital was also a material income-producing factor, the Code expressly includes a ceiling on that portion of the net profits which can be considered compensation for the owner's services, the limitation being 30%. ⁶⁰ A realistic apportionment may, of course, call for exclusion of less than 30%; that figure is only a ceiling. ⁶¹

Differences between the two forms of enterprise may also be important with reference to the loss of an exclusion in the case of "amounts paid by the United States or an agency thereof." For example, because of this statutory language, it has been held that an exclusion will not be enjoyed with reference to the distributive share of a professional partnership's profits which arose out of a government contract with the firm for its foreign services. ⁶² On the other hand, where one is truly an officer or employee of a corporation, he will not lose the benefit of the exclusion merely because the employer is working on a government contract. ⁶³

While the Code excludes earned income attributable to a qualified period *only* if it is "received from sources *without* the United States," the latter requirement is satisfied if the personal services

⁵⁸ I.R.C., § 911(b).

⁵⁹ *Ibid.*

⁶⁰ *Ibid.*

⁶¹ I.T. Regs., § 1.911-1(a)(5).

⁶² Leif J. Sverdrup, 14 T.C. 859 (1950). But that case did approve the exclusion with respect to a so-called salary paid one partner.

⁶³ Rev. Rul. 54-483, C.B. 1954-2, 168. Cf. Rev. Rul. 58-4, C.B. 1958-1, 268.

are "performed" abroad.⁶⁴ The "place of receipt" is immaterial.⁶⁵ But *only* under the bona-fide-residence test is the *time* of receipt immaterial. Under that test, deferred payments which are attributable to earlier foreign service and are paid in the years *following* the employee's return to the States may be excluded if the other requirements are satisfied.⁶⁶ In some instances, a contractually deferred payment of this type may completely escape taxation because of the inability of a Common Market country to collect tax once the American has returned to his native land. However, if the amount in question is properly chargeable for tax purposes to a foreign permanent establishment or is paid by a foreign subsidiary, in all probability the withholding requirements of a particular Common Market country at least theoretically apply.⁶⁷ But in five of the Common Market countries this is probably not the case if the contractually deferred compensation takes the form of a "pension." It is assumed in this connection that the American citizen abandoned his foreign residence immediately upon returning to the United States, concurrently re-establishing his residence in his native land, after which the contractual "pension" payments were to be received. Bilateral tax treaties with the five provide that private pensions paid to American citizens residing in the United States will not be taxed by the Common Market country even though the latter is the source from which the pension is derived.⁶⁸ And "pensions" are generally defined in those treaties, illustratively in the case of Belgium, to mean "*periodic* payments made in consideration of services rendered or by way of compensation for injuries received."⁶⁹

In the case of qualified funded retirement plans having their situs in the United States, unless an American working and residing in a Common Market country is taxed by the latter at that point of time when contributions to the fund were made by the American employer,⁷⁰ a significant part of pension payments subsequently re-

⁶⁴ I.R.C. §§ 911 and 862(a)(3), respectively. (Italics added.)

⁶⁵ I.T. Regs., § 1.911-1(a)(6) and (b)(5); James D. Mooney, 9 T.C. 713 (1947); Herman A. Kollmar, 4 T.C. 727 (1945).

⁶⁶ Rev. Rul. 55-294, C.B. 1955-1, 368.

⁶⁷ The benefit in any event is believed to be taxable in Belgium and the Netherlands, though difficulty in realizing upon the claim is recognized. In Germany, while so-called "home salaries" are fully taxable, the tax authorities have held that bonuses paid an employee *after* he has finished his work in Germany are not taxable.

⁶⁸ Article X of the Belgian treaty is illustrative. On the other hand, the treaty with South Africa provides an opposite rule. Art. VIII(2). Cf. Rev. Rul. 56-235, C.B. 1956-2, 1125.

⁶⁹ *Ibid.* (Italics added.)

⁷⁰ It would be particularly surprising if a Common Market country would attempt currently to tax the employee on the employer's contribution if the employee's rights

ceived following the employee's return to the States will also be completely immune from tax. Such pension payments would be immune from American tax in the proportion the payment is directly attributable to the contribution which the employer made with reference to that earlier foreign service which qualified under the foreign bona-fide-residence test.⁷¹ However, that portion of the pension which represents earnings on or accretion in the value of those employer contributions will not be excludable for American tax purposes, for that part does not really constitute "earned" income entitled to the § 911 treatment.⁷² If the American has re-established residence at home, the treaty provisions noted above would, of course, foreclose the Common Market country from asserting tax liability by reference to the pension payments themselves, even if collection of tax were otherwise possible. The same overall degree of tax freedom might even be enjoyed by returning American employees who are beneficiaries of certain types of funded plans which have their situs in a Common Market country.⁷³

Returning employees whose foreign status qualified only under the 510-day rule will not fare so well, with reference at least to certain deferred compensation arrangements. Their difficulty stems from the way the government interprets the \$20,000 limitation. Until this limitation was added, amounts which qualified under the 510-day rule, like those associated with the bona-fide-residence test, were excludable from gross income "irrespective of when they. . . [were] received."⁷⁴ But in fixing the \$20,000 ceiling, the statute was amended to read as follows:

the amount excluded under this paragraph for such taxable year shall not exceed \$20,000. If the 18-month period does not include the entire taxable year, the amount excluded under this paragraph for such taxable year shall not exceed an amount which bears the same ratio to

were not vested. In the Netherlands, it is not believed that the benefit will be taxed in any event as long as the contribution is to a regular pension arrangement. Germany will immunize contributions at least if made to a company administered fund.

⁷¹ Rev. Rul. 59-278, C.B. 1959-2, 174, indicates certain variations geared to date-lines corresponding to various amendments made to § 911's bona-fide-residence rule. See also Rev. Rul. 56-125, C.B. 1956-1, 627; Rev. Rul. 56-571, C.B. 1956-2, 982; and Goodman, *The Unique Status Of Foreign Service Pensions Offers Tax Advantages* 11 JOURNAL OF TAXATION 30 (1959).

⁷² *Ibid.*

⁷³ I.R.C., § 402(c) and note 71, *supra*. The statement assumes, with reference to an exclusion under foreign tax law for contributions made by the employer, that the foreign trust also meets requirements that might be imposed by foreign tax law.

⁷⁴ Rev. Rul. 54-72, C.B. 1954-1, 117 at 118 and I.T. Regs. (1939), § 39.116-1(b) as amended by T.D. 6039, C.B. 1953-2, 162.

\$20,000 as the number of days in the part of the taxable year within the 18-month period bears to the total number of days in such year.⁷⁵

On the one hand, Congress clearly intended to restrict the \$20,000 per year ceiling by a further pro-tanto type of limitation where the period of absence in a particular year was less than the whole year.⁷⁶ The Treasury, however, also interprets the statutory language to mean that no exclusion will be permitted if none of the actual payment was *received* in a taxable year which fell, at least in part, within the 18-month period.⁷⁷ According to its interpretation, where a calendar year taxpayer qualified under the 510-day rule and left Europe on July 1, 1960 for reassignment to the States, a maximum compensation of approximately \$10,000 would be excludable provided it was attributable to the foreign service *and* was received *within* the taxable year 1960, a part of which did fall within the 18-month period. No part of any payment received in 1961 would qualify, however, even if it were the only compensation the taxpayer received for that six months of foreign service which fell in 1960.⁷⁸ It is quite possible that these limitations, developed in the setting of deferred contractual payments, will also serve to restrict immunity with regard to pension payments under funded plans if the returning taxpayer's foreign status qualified only under the 510-day rule.

Taxpayers who enjoy the benefit of a § 911 exclusion will not be permitted to offset other U.S. income by deducting expenses allocable to the excluded amounts. But while the Code denies a deduction for any expense which is "properly allocable to or chargeable against" excluded amounts,⁷⁹ so-called personal deductions, such as personal exemptions, charitable contributions, real estate taxes on a home, interest paid on a mortgage against the home, and medical expense are not adversely affected; these are not deemed allocable to any particular income item.⁸⁰

(e) *Conclusion re Americans working abroad: Filing requirements, etc.*—Traditionally, Americans have been required to

⁷⁵ Technical Changes Act of 1953, § 204(a), now reflected in I.R.C., § 911(a)(2). (Italics added.)

⁷⁶ S. Rep. No. 685, 83d Cong., 1st Sess. 5 (1953); C.B. 1953-2, 526, 528-529.

⁷⁷ I.T. Regs., § 1.911-1; Rev. Rul. 54-72, C.B. 1954-1, 117.

⁷⁸ *Ibid.*

⁷⁹ I.R.C., § 911. Where the \$20,000 limitation precludes a complete exclusion of foreign earned income, deductions chargeable to such income are lost on the same proportionate basis. I.T. Regs., § 1.911-1(b)(6).

⁸⁰ I.T. Regs., § 1.911(a)(3) and (b)(6).

file an income tax return when their gross income exceeded \$600, or in the case of those over 65 years of age—\$1200.⁸¹ Even before a recent statutory amendment, this meant that many who had gone abroad to work would still have to file a domestic return. Americans working abroad frequently realized more than \$600 (or \$1200 as the case may be) in other than *foreign* "earned income" to which the special exclusion was confined. In fact, even with this exclusion and a full allowance for so-called personal deductions including full exemptions, returns of many of them could easily show that some tax was actually owing to the United States. This was so even if the non-excluded income was also derived from a foreign source, for the cumulative effect of the credit and deduction for foreign taxes will not necessarily wipe out the American tax liability. The Internal Revenue Service reported to Congress, however, that many such Americans were not even filing a domestic return, in part because they apparently supposed that their entire income was excludable.⁸² Certainly it is more difficult for an American working abroad to obtain information concerning his domestic tax liability, if any, than it is for those working in the States. In any event, absence of the information which would have been disclosed by such returns made it difficult for the Service to pick out those taxpayers whose affairs should be audited. Congress responded to this problem in 1958 by providing that even the foreign income which qualifies for an exclusion in determining tax liability will be included in gross income but *only* for the purpose of determining whether the taxpayer had an amount of gross income (\$600, or \$1200 if over 65 years of age) sufficient to require the filing of a return.⁸³ The obvious effect is that practically all Americans working abroad must now file a domestic return, though in the end many of them will not actually owe an American tax.

Because of the difficulty in filing a return if one is abroad on the regular filing date, the Treasury has granted an automatic extension of 3 months to calendar year taxpayers and 2 months to taxpayers on a fiscal year.⁸⁴ A delay of 3 months is also allowed in the case of declarations of estimated tax, and while this extension is granted without any charge for interest, it is otherwise in the case of the final return.

Where a citizen, on departure from the United States, contem-

⁸¹ I.R.C., § 6012.

⁸² S. Rep. No. 1983, 85th Cong., 2d Sess. 93 (1958).

⁸³ Technical Amendments Act of 1958, § 72, amending I.R.C., § 6012.

⁸⁴ Rev. Rul. 55-171, C.B. 1955-1, 80.

plates compliance with the 510-day requirement, the final return for the taxable year during which he left will normally be due before that exclusionary standard has been satisfied. The Congress and the Service have accommodated themselves to this problem. The former has provided that the government's authority to grant extensions only up to 6 months shall not be so limited in the case of those who are abroad.⁸⁵ In turn the Treasury has issued a ruling whereby one who desires to postpone determination of his tax liability until the exclusionary standard is met may, upon request, obtain a special extension regarding the regular filing date.⁸⁶ Otherwise the matter will be handled on a refund basis.

SECTION D. TAX IMPLICATIONS OF BUSINESS VISITS BY EMPLOYEES BETWEEN THE UNITED STATES AND COMMON MARKET NATIONS

(a) *Introductory note.*—The preceding discussion in Section C outlined the requirements which an American citizen working in a Common Market country must meet if he hopes to obtain an exclusion of his foreign service income under § 911 of the Code. But even if such an exclusion is obtained, that individual may complicate his tax problem by making short intermittent visits back to the States. Double taxation will normally be avoided, however, for as noted in Section B, *supra*, most Common Market countries will defer in one degree or another to the American tax on compensation attributable to his work in the States, with Luxembourg having the least attractive arrangement—a deduction of the American tax from gross income.

Less tax complication will normally be encountered on similar trips made by a Common Market country citizen who has been working in his native land for an American owned facility. The same is true of trips made abroad by Americans who normally work at the enterprise's head office in the United States. In these two cases, as distinguished from the situation first mentioned, the country being visited normally forgoes its right to tax any compensation attributable to services performed there.

The aims and period of time covered by such trips may run the gamut, from very short stays designed to enable the individual to purchase merchandise and equipment, to longer excursions devoted

⁸⁵ I.R.C., § 6081(a).

⁸⁶ Rev. Proc. 57-33, C.B. 1957-2, 1106 and Rev. Rul. 55-171, C.B. 1955-1, 80.

to an analysis of sales promotion and production techniques of the head office, of the foreign facility, or of a foreign licensee to whom "know-how" must be communicated. A vacation may also be thrown in for good measure.

The extent to which arrangements have been made to simplify the tax problems associated with trips made by the three classes of individuals described above is indicated in the discussion which follows.

(b) *Intermittent trips to the States during the period an American is otherwise qualified for the § 911 exclusion.*—Satisfaction of the foreign-bona-fide-residence test or the alternative 510-day rule of § 911 of the Code serves only to exclude an American citizen's *foreign* earned income.⁸⁷ Compensation attributable to his business trips back to the States are not affected by those statutory tests.⁸⁸ The Code itself expressly designates the foreign country as the "source" of compensation only with respect to services "performed" there.⁸⁹ Thus the place or origin of payment with respect to work done on a business trip back to the States is irrelevant;⁹⁰ the amount so attributable must be included in American gross income under § 61.

The statutory requirement that such compensation be included is not neutralized by the bilateral tax treaties which the United States has entered into with five of the Common Market countries. From a casual reading of those treaties, one might at first think otherwise if the American has become a resident of a Common Market country for tax purposes; those treaties do open by extending to Common Market "residents" an exemption from United States tax in the case of income earned from services performed in the States during the course of brief business trips.⁹¹ But those treaties close with a reservation which accomplishes the same result which the American treaty with the United Kingdom more directly accomplished by definition. Whereas the latter expressly defines English "residents" for this purpose so as to exclude "a citizen of the United States,"⁹² the treaties with the Common Market countries achieve a like result through a provision which expressly reserves to the

⁸⁷ See discussion in Section C, *supra*.

⁸⁸ I.R.C., § 861(a)(3) provides the only exclusion for circumstances of this type, and it is limited to nonresident aliens. See subtopics (c) and (d), *infra*.

⁸⁹ I.R.C., § 862(a)(3).

⁹⁰ I.T. Regs., § 1.861-4(a).

⁹¹ Articles XI, 9, XI, XI, and XVI, respectively, of the treaties with Belgium, France, Germany, Italy, and the Netherlands.

⁹² Article II(i)(g).

United States the right to tax its own citizens under the regular provisions of the Internal Revenue Code.⁹³

The fact that the compensation attributable to the United States trip is includible in his American gross income does not necessarily mean that the citizen will actually suffer an American tax. In most cases, of course, he would have had to file a United States return—though perhaps showing no actual tax liability—even in the absence of the trips in question.⁹⁴ If that compensation which is attributable to business trips to the States is the only income he realizes other than that excluded under § 911, the fact that he will be allowed full exemptions for himself and his dependents, as well as all other purely personal deductions,⁹⁵ may leave him with little or no American net or “taxable income.” However, where the compensation is completely neutralized for American tax purposes by offsetting personal deductions, in only one instance is it probable that such compensation will completely escape taxation. Assuming in this connection that the American citizen has become a resident of the Common Market country in which he is stationed, he will usually find that the income attributable to his trip back to the States is also includible in the return which he files with that member nation.

This would be so if the country were Luxembourg; and there only a deduction in computing the tax base would be allowed for any American tax—here assumed to be none because of exemptions, etc.—which he might have paid. However, some of the other Common Market countries are more liberal with reference to earned income which a resident American derived from his native land. According to the discussion in PART I, the Netherlands would completely exempt the compensation in question even though an American tax is not actually suffered because of the offsetting personal exemptions, etc.⁹⁶ That income will be taken into account, however, for the purpose of determining the Dutch rate on the taxpayer’s other income.

While the bilateral tax treaties with five member nations include a provision aimed at compensation derived by a nonresident citizen

⁹³ Articles XII, 14, XV, XV, and XIX, respectively, of the treaties with Belgium, France, Germany, Italy, and the Netherlands.

⁹⁴ Every American citizen, as well as certain others, must file a U.S. return if he has a gross income over \$600, or if over age 65, of \$1,200. And for this purpose, but only this purpose, foreign service income otherwise excludable must be included. I.R.C., § 6012(c).

⁹⁵ I.R.C., § 911 deprives him only of those deductions properly chargeable to the excluded income. See discussion in Section C, *supra*.

⁹⁶ PART I, Section F(i)(h).

from his native land, they are not usually so liberal as is the unilateral treatment accorded by the Netherlands.⁹⁷ For example, the rate reduction formula of the Belgian treaty which was more fully discussed in Section B, *supra*, applies only where the compensation derived from American sources was "taxed by the United States."⁹⁸ The treaty with Germany, also more fully described in Section B, calls for an exemption, but only if the item was "not exempt from United States tax."⁹⁹ And, of course, the credit which Italy would allow springs into operation only if the compensation did, in fact, suffer an American tax.¹⁰⁰

A vacation, rather than business, may motivate a return trip to the States by an American who qualifies for a § 911 exclusion under the foreign-bona-fide-residence rule. The absence of labor or services in the United States should mean that any compensation attributable to the vacation period will not have its source within the United States, but will instead be attributable to work previously done abroad and should then also come within § 911 if otherwise qualified.¹⁰¹

After a certain period of foreign service, some employers pay the transportation expenses associated with a vacation back to the States, covering the employee's family as well as the employee. Even if such a benefit is deemed additional income under American tax concepts, it would appear to be attributable to the foreign service and, therefore, also excludable by one who is qualified under the foreign-bona-fide-residence test.¹⁰² The same should be true of one

⁹⁷ Indeed, the treaty with Netherlands requires only a credit to the extent permitted by its law.

⁹⁸ Article XII(3).

⁹⁹ Article XV. The leading commentary on Germany's tax treaties, that by Korn-Dietz, confirms the effective taxability requirement at p. USA-35.

¹⁰⁰ Article XV.

¹⁰¹ Cf. *Chidester v. United States*, (Ct. Cl. 1949) 82 F. Supp. 322; Rev. Rul. 57-316, C.B. 1957-2, 626. An apportionment problem may arise where a part of the vacation is attributable to the period in which work was done in the United States.

¹⁰² It is entirely possible that one or more Common Market countries would treat this as a taxable benefit attributable to work done there. This is believed to be the rule in the Netherlands and in Germany. In the latter country, however, some immunity might be obtained under § 31 Abs. 1 EStG (Income Tax Act) pursuant to which those immigrating to Germany may petition the highest tax authorities of the Länder for the purpose of obtaining by negotiation a lump sum settlement of their income tax during each of the first 10 years. While no reduction is ordinarily granted under this provision with respect to income arising in Germany, it is entirely possible that special treatment might be obtained for matters such as the vacation trip in question. Indeed, in order to obtain the limited deduction allowed for life insurance premiums, a taxpayer who makes such payments to an American company must invoke the above procedure if he is to have any chance to enjoy the deduction; the statute itself limits such deductions to premiums paid German companies.

qualified under the 510-day rule, but in that circumstance the additional amount may run the employee over the \$20,000 per year limitation. In such event, as well as in the case where the employee falls completely short of § 911, it would be necessary to determine whether such benefit is actually embraced by the American concept of income. On the one hand, it is clear that vacation expenses paid by an employer for a domestic employee's trip *within* the United States constitutes additional income to him.¹⁰³ However, to extend this principle to those transportation expenses which are designed to allow the employee and his family to return for a vacation in his native land would embarrass even the United States government itself. For, as an employer, it too pays transportation expenses associated with vacation trips to the States by foreign service officials of the State Department.¹⁰⁴ The Internal Revenue Service has not yet, however, published the position it will ultimately take in such cases.

It is not unusual for a visiting American citizen employed abroad to dovetail a vacation with his business trip to the States. And in trying to keep compensation attributable to United States sources within an amount which can be offset by his personal exemptions and deductions, it may be important to such persons that the time spent vacationing be isolated. To provide adequate safeguards in the event his return is audited, it may be desirable for the employee to have a realistic written understanding with the employer regarding the respective amounts of time to be devoted to the two different purposes.

(c) *American statutory exclusion designed to accommodate intermittent trips to the States by Common Market citizens.*—The American tax problems which will be encountered by the typical nonresident alien who is temporarily brought to the United States for business purposes will usually be much less complex than are those associated with like trips by American citizens residing abroad. Congress has always drawn a sharp distinction between citi-

It is doubtful that Belgium would tax the benefits associated with the vacation trip. At least it recently immunized such payments with respect to employees returning on vacations from what until recently had been the Belgian Congo. While such benefits are probably theoretically taxable in France, in practice it is believed that the tax authorities will ignore the matter unless the expense is charged to the branch or subsidiary doing business there.

¹⁰³ Any other result could hardly be justified in the face of sweeping language like that found in *Comm'r. v. Lo Bue*, 351 U.S. 243, 76 S. Ct. 800 (1956); *Rutkin v. United States*, 343 U.S. 130, 72 S. Ct. 571 (1952). See Rev. Rul. 57-130, C.B. 1957-1, 108.

¹⁰⁴ 22 U.S.C. §§ 1136 and 1148.

zens and residents, on the one hand, and nonresident aliens on the other, being content in the latter case to reach nothing more than gross income which was derived from sources *within* the United States.¹⁰⁵ Until 1936, this was enough, however, to call for inclusion of *all* compensation attributable to *any* labor or service performed by the nonresident alien in the States.¹⁰⁶ In that year, however, Congress did add a specific statutory exclusion designed to accommodate, within limits, compensation attributable to short business trips. Later, the Senate ratified tax treaties with five of the Common Market countries, and in some circumstances these included even more generous exclusionary standards with respect to such income. But alien employees from the sixth country (Luxembourg), and in some situations those from the other five can look only to the statutory exclusion for protection, if any. And sometimes the employee will fall short of the exclusionary corridors marked out by both, coming face to face then with the *overall* statutory tax treatment of nonresident aliens. The latter pattern may also be important for other reasons. For example, some of the treaties do not immunize a nonresident alien's capital gains which have their source in the States. Since employees of the type in question may well own American securities, particularly in the American enterprise with which they are directly or indirectly associated, the statutory treatment of such may be important. Indeed the existence of such a gain can even affect the American tax on that part of a visitor's *earned* income attributable to services performed during his business trips to the States. However, this study is confined to the exclusionary arrangements designed to accommodate international business trips. Because the American statutory exclusion still has practical significance, it will be discussed first; an analysis of the related provisions in the tax treaties will then follow.

Since compensation for labor or personal services performed in the States was deemed to have its source there, without regard to the origin or place of payment, Congress early found it necessary to add a collection procedure requiring the nonresident alien, upon his departure from the States, to file what was tantamount to an information return and pay a tentative tax or provide security therefor,¹⁰⁷ notions which survive to this day.¹⁰⁸ This demand for pay-

¹⁰⁵ Rev. Act of 1913, Section II, § A, Subdiv. 1, now I.R.C., § 872.

¹⁰⁶ Rev. Act of 1921, § 217(a)(3), now I.R.C., § 861(a)(3). If the trip is solely a business trip, the service attributed to the States will presumably begin when the person comes within the territorial limits. Cf. I.T. Regs., § 1.861-4(c).

¹⁰⁷ Rev. Act of 1921, § 250(g).

¹⁰⁸ I.R.C., § 6851(d). See also T.I.R. No. 225, April 21, 1960, '60 Vol. 6 CCH para. 6442.

ment before an alien business visitor could leave the country was later found by a congressional committee to have "created irritation and ill will quite disproportionate to the slight revenue involved."¹⁰⁹ It was that committee which then pushed through a statutory exclusion which was expressly confined to those cases where labor or services were performed as an employee or under contract with truly foreign entities not engaged in a trade or business in the United States. In other words, the employee could not qualify for the exclusion if the employer, not otherwise engaged in a trade or business in the States, was other than a "nonresident alien, foreign partnership, or foreign corporation."¹¹⁰ This had the effect, *inter alia*, of rendering ineligible for the exclusion nonresident alien employees of the foreign *branch* of an American corporation.¹¹¹ Later, as is more fully discussed below, a like limitation was incorporated in some of the tax treaties. But still later, after those treaties were signed, Congress extended the statutory exclusion, qualifying also local services performed by a nonresident alien for an office or place of business maintained in a foreign country by an American corporation.¹¹²

Before that amendment, as well as now, the exclusion was otherwise available only where the nonresident alien (1) was temporarily present in the States for periods not exceeding a total of 90 days during the taxable year, and (2) then only if the compensation for the services rendered here did not exceed \$3,000 in the aggregate.¹¹³ Failure on either count results in a loss of the entire exclusionary privilege.

As is true of Americans who are employed by a foreign facility to work abroad, it is not unusual for nonresident aliens to dovetail vacations with business trips to the States. And in trying to stay within the aggregate \$3,000 statutory limitation, it may also be important to such persons that the time spent vacationing be isolated. Even though they are entitled to a so-called "paid vacation," compensation attributable to the period devoted to sightseeing, etc., is free of American tax without regard to the specific statutory exclusion. The absence of labor or services in that part of the period devoted to vacationing means that the applicable compensation is *not* from sources *within* the States,¹¹⁴ and is, therefore, beyond the

¹⁰⁹ S. Rep. No. 2156, 74th Cong., 2d Sess. 22 (1936).

¹¹⁰ Rev. Act of 1936, § 119(a) (3).

¹¹¹ I.T. 3943, C.B. 1949-1, 83.

¹¹² I.R.C., § 861(a) (3).

¹¹³ *Ibid.*

¹¹⁴ Cf. the philosophy of *Chidester v. United States*, (Ct. Cl. 1949) 82 F. Supp. 322.

reach of the American tax gatherer under the *general* rule which confines the gross income of nonresident aliens to that which has its source within the States.¹¹⁵

To facilitate a proper apportionment, for tax audit purposes, of that compensation attributable to the vacation portion of the trip, it may also be desirable for these employees to have realistic written understandings with employers regarding the respective amounts of time to be devoted to the two different purposes. It must be remembered, however, that the quite separate 90-day limitation relates to the aggregate physical presence in the United States without regard to purpose. But where this period is too short to accommodate all of the visitor's purposes, it may be possible to salvage tax immunity either by resorting to what may be a more generous provision in the governing treaty or by spreading his presence in the States across two taxable years. The fact that the statutory 90-day limitation is geared to aggregate presence "during *the* taxable year"¹¹⁶ means that a visitor who comes to the States in the last quarter of a taxable year, and otherwise qualifies, can safely spread his visit over into the first quarter of the succeeding taxable year.

Similar planning may be useful to an alien visitor who would otherwise be entrapped by the separate statutory \$3,000 limitation. For example, one who earns \$3,000 for each 30-day period and plans to stay 45 days may qualify by starting his visit in December, thus taking advantage of two qualifying amounts instead of one. But it seems worthwhile to repeat that failure to satisfy either one of the two different limitations means loss of the entire statutory exclusionary privilege.

Many persons will not be able to take advantage of the spreading devices related above. In certain circumstances they may still obtain refuge from the American tax by relying on more generous standards which appear in certain of the tax treaties discussed immediately below, provided they can also meet the other treaty specifications.

(d) *Reciprocal treaty exclusions to accommodate a Common Market citizen's trips to the United States and an American citizen's trips abroad.*—Each of the American treaties with five of the member states provides for a specific exclusion of compensation attributable to "labor or personal services" performed within the United States by "residents," whether or not citizens, of the specific

¹¹⁵ I.R.C., § 872(a).

¹¹⁶ I.R.C., § 861(a)(3).

Member State.¹¹⁷ The same treaty articles include a reciprocal provision, designed to accord like treatment in the case of business trips to Europe by Americans whose normal employment stations them in the United States.

Table V B, which appears at the conclusion of this sub-topic, indicates the varying requirements expressly reflected in the relevant provisions. From it, laying aside refinements, two different basic patterns emerge.

First, all of the treaties establish a wider tax free corridor than that made available to visiting nonresident aliens by the American statute, *provided* the employer is a resident or other entity of the traveler's own residence. Where that important condition is met, an exclusion is allowed by the country being visited *regardless of the amount* of compensation involved so long as the aggregate periods of physical presence there do not exceed what generally approximates *twice* the aggregate time permitted by the Code in the case of nonresident aliens. Under all treaties, except that with Italy, the aggregate periods of physical presence in the country being visited may extend through 183 days during any one taxable year. The Italian treaty is identical with the Code in restricting the periods to a total of 90 days in any one year.

The second basic grouping relates to the question of whether any exclusion at all is provided for in the instance where the employer is other than a resident or entity of the visitor's own place of residence. One of the treaties—that with the Netherlands—like the earlier American Code provision which existed when that treaty was signed, does not permit an exclusion in such cases.¹¹⁸ But where residents of that member nation are employed by *branches* of an American corporation, on visiting the States they may now look to the amended statutory provision which does authorize an exclusion in such cases, but then the other statutory specifications must also be satisfied. In other words, the absence of a treaty authorization does not prohibit reliance on statutory privileges accorded by the American Code.

Treaties with the other four countries do authorize an exclusion in such cases, though three of the four impose an amount limitation similar to that imposed by the American Code. The treaties with

¹¹⁷ Articles XI, 9, X, IX, and XVI, respectively, of the treaties with Belgium, France, Germany, Italy, and the Netherlands. American citizens, resident in such countries, would not be eligible, however, for this exclusion. See discussion, sub-topic (b) *supra*.

¹¹⁸ The French treaty was originally so limited, but it was later amended to accommodate employees of a corporation's foreign branch.

Belgium and Germany require that the aggregate amount of compensation in any one year must not exceed \$3,000; the Italian treaty restricts the amount to a total of \$2,000. Only the French treaty allows an exclusion in this circumstance without regard to the amount. Moreover, in this circumstance, i.e., where the employer is other than a resident or entity of the traveler's place of residence, only in the French and German treaties may the aggregate period of the visits during any one year exceed that authorized by the Code to nonresident aliens. Those two treaties conform in this circumstance to the time limitation applicable in the opposite situation, i.e., to 183 days in any one taxable year. The conventions with Italy and Belgium, like the Code, contain a more confining 90-day restriction.

Finally it should be noted that certain kinds of personal activity are ineligible for exclusions otherwise made available by treaty. Illustratively, the treaty with Belgium specifically denies the exclusion to an otherwise qualified American who visits Belgium in order to perform his function as a director of a Belgian corporation. While the German treaty provides otherwise in the case of the nonresident visiting director, it should be noted that under German law the remuneration of nonresident directors of German corporations are taxed even if they never set foot in Germany.

The prime standards set forth in the various treaties, as well as those prescribed by the American statute to deal with the case of nonresident aliens visiting the United States, are consolidated in the chart which follows, insofar as they affect four situations:

- (1) The exclusion allowed by Common Market countries, pursuant to treaty, in the case of visiting American citizens who regularly work in the States for the home office; and
- (2) The exclusion allowed by the United States where a Common Market country citizen who is regularly employed in his native land visits the American company's home office in the States. In this situation, the chart reflects those differences, if any, which are dependent upon whether the visitor was regularly employed by the American company's (a) foreign subsidiary or a foreign incorporated licensee, (b) foreign permanent establishment, or (c) home office, the employee serving regularly as a Common Market promotional representative.

NETHERLANDS TREATY—ARTICLE XVI

Required Locus Of Compensation Burden
 —Employer located in visitor's place of residence must bear actual burden of compensation

<i>Statutory Exemption from U.S. Tax Re Nonresident Aliens Visiting U.S.</i>	<i>Belgian Exemption: American Citizen Resident, Employed by U.S. Corp., Visiting Belgium (2e)</i>	U.S. Exemption: Aliens (Belgian Residents) Visiting U.S. (2d)			<i>French Exemption: American Citizen Resident, Employed by U.S. Corp., Visiting France (2c)</i>	U.S. Exemption: Aliens (French Residents) Visiting U.S. (2c)			<i>German Exemption: American Citizen Resident, Employed by U.S. Corp., Visiting Germany (2a), (2b)</i>	U.S. Exemption: Aliens (German Residents) Visiting U.S. (2a), (2b)			<i>Italian Exemption: American Citizen Resident, Employed by U.S. Corp., Visiting Italy (2b)</i>	U.S. Exemption: Aliens (Italian Residents) Visiting U.S. (2b)			<i>Netherlands Exemption: American Citizen Resident, Employed by U.S. Corp., Visiting Netherlands</i>	U.S. Exemption: Aliens (Netherlands Residents) Visiting U.S.		
		<i>Employee of Belgian Corporation</i>	<i>Employee of Permanent Establishment in Belgium</i>	<i>Employed Directly by U.S. Corp.</i>		<i>Employee of French Corporation</i>	<i>Employee of Permanent Establishment in France</i>	<i>Employed Directly by U.S. Corp.</i>		<i>Employee of German Corporation</i>	<i>Employee of Permanent Establishment in Germany</i>	<i>Employed Directly by U.S. Corp.</i>		<i>Employee of Italian Corporation</i>	<i>Employee of Permanent Establishment in Italy</i>	<i>Employed Directly by U.S. Corp.</i>		<i>Employee of Netherlands Corporation</i>	<i>Employee of Permanent Establishment in Netherlands</i>	<i>Employed Directly by U.S. Corp.</i>
X			X	X									X	X	X	X				
	X	X			X	X	X		X	X	X	X					X	X		
X															X	X				
	X	X	X	X	X	X	X		X	X	X	X	X				X	X		
					X	X	X													
	X	X							X	X			X	X			X	X		
X																				
	X	X							X	X							X	X		

“fixed center” in that country. T.D. 5499, § 7.412(f) of the United States regulations interprets this latter limitation to mean that a visiting French doctor, lawyer, engineer, or other member of a liberal profession will enjoy an exclusion from U.S. tax provided he “does not maintain within the United States an office, installation, or other fixed center relating to the practice of his profession.”

(d) Specifically excluding remuneration of officer or director of U.S. corporation.

(e) Specifically excluding remuneration of “administrateurs,” ‘commissaires,’ or ‘liquidateurs’ of, or of other individuals, exercising similar functions in corporations created or organized in Belgium.”

PART VI. THE FUTURE TAX SITUATION AS IT MAY AFFECT DOING BUSINESS IN THE COMMON MARKET

Introductory note.—Foreign political relations aside, many businessmen are convinced there are few norms as unstable as those embodied in tax laws. Despite the existence of an almost day-to-day amending process, too great attention to these amendments can be misleading, for more often than not, it is tantamount to a “cleaning up” operation.

Revision of internal *basic* principles, affecting as they do the whole economic paraphernalia of a nation, is not easily achieved. Newly founded *external* relationships, such as those formed through the establishment of the European Common Market, do, however, tend to force each affected member nation to undertake a more penetrating examination into the basic structure of its tax laws. Other countries, such as the United States, who would do business with such newly founded communities may be likewise affected.

The likelihood of basic changes in the Common Market tax picture is the subject matter of the abbreviated discussion below in Section A. Subsequent Section B identifies the relevant major changes which are being given thoughtful consideration in the United States.

SECTION A. FUTURE TAX SITUATION IN THE COMMON MARKET

(a) *Tax premises of the Common Market treaty.*—Those who framed the Common Market treaty apparently concluded that tax aspects relevant to greater economic cooperation were too complicated to solve in the treaty itself. The latter has only a few provisions bearing on the subject (Articles 95–99), and these deal *only* with *indirect* taxes (turnover taxes and excise duties). Direct taxes (income, property, and enterprise taxes) are not specifically mentioned; Article 220 does, however, refer to the necessity of avoiding double taxation.

With respect to *indirect* taxes, all of the relevant provisions but

one assume the existing tax pattern and provide only for certain limitations. The one exception, Article 99, charges the Commission (the Community's principal administrative body) with the responsibility of conducting a study in order to determine how these taxes might be harmonized. The preceding Articles of the treaty assume continuation of the existing practices with reference to exports and imports, as more fully described in PART II, *supra*. In the case of exports, refund of turnover taxes previously paid is limited to those actually suffered by the product. In short, a refund system may not be used as a device by which to subsidize export trade. The aim on the import side, on the other hand, was to preclude the possibility of disguised tariffs; thus turnover taxes imposed on imports may not exceed the burden assessed with respect to similar products manufactured in the importing country itself.

(b) *The likelihood and adequacy of harmonized indirect tax systems.*—Appraisal of the logic behind the treaty provisions should turn on the extent to which the incidence of taxation is actually a factor in fixing competitive conditions.

The treaty assumes that *indirect* taxes are in the nature of costs which directly influence competition in that they are passed on to the consumer. In other words, if the same article is subject to a different tax burden, and if all other costs are equal, that which suffers the least tax burden will be more easily sold. From this premise, many tax specialists are led to the conclusion that in a community like the Common Market all merchandise must bear the same indirect taxes, without regard to the country of origin. From this, it would follow that the exporting country must refund all previously paid turnover taxes, and the importing country should levy a tax identical to that imposed on locally manufactured merchandise.

Apart from the merits, an almost insurmountable practical difficulty will be encountered in effectuating this scheme unless the member nations revise the basic structure or theory of their respective turnover taxes. As indicated in PARTS I and II, *supra*, five of the six members levy a multiple stage tax, i.e., one on each succeeding stage in the production and distribution process. This fact alone would make it difficult to develop a refund formula which would be accurate in each case. Each product bears different cost factors, starting with raw materials and spreading across plant, machinery, and overhead costs, each of which comprise a different tax element. Theoretically, the French added-value tax (*Taxe sur la Valeur*

Ajoutée) is the only one which can compensate for these difficulties. And in Germany, where reformation of the turnover tax system is under advisement, there are those who favor the adoption of the French system, though experience has exposed deficiencies in the latter system also. As indicated in Sections A and D of PART I, *supra*, with reference to some products, Italy and Belgium have substituted a single transfer tax for the otherwise applicable multiple-stage arrangement, but the substitution was not effected with reference to a host of products, such as raw materials, machinery, etc.

In any event, adoption of one turnover tax system by all member nations is not to be expected in the near future. Nor would such a move serve actually to equalize tax burdens. Three reasons, each shading into the other, contribute to the difficulty.

First, because economic and social circumstances in the six countries differ, different systems of *exemptions* and *internal* variations in applicable rates will have to be maintained by most member nations. This, of course, makes calculation of the exact burden borne by a given product more difficult.

Second, the Introduction to PART III, *supra*, indicated the differences in the degree to which each member nation relies upon indirect taxes, as distinguished from *direct* taxes. The variation is considerable and attributable to differences to be found in the tax psychology of the member nations. Illustratively, France and Italy would now find it almost impossible to impose higher taxes on income. On the other hand, it would be equally difficult to raise indirect taxes in the Netherlands and Luxembourg, and to a lesser extent in Germany. Admittedly, this problem would be of less significance to international trade if the amount of indirect taxes could be accurately determined and refunded at export, while being levied on imports in an amount exactly equal to that borne by local products. Enthusiasm for this, as a solution, has been dampened, however, by the third and final major consideration.

In this latter connection, there is growing awareness that *direct* taxes—matters not really dealt with by the Common Market treaty—also influence competition. Laying aside direct taxes on the income of individuals such as wage earners (though such might also be shifted), greater numbers have come to the realization that enterprise taxes, such as the corporate income tax, will influence the price of manufactured products. A common illustration in the international setting should suffice. Assume that two companies from different countries (A and B) bid on the right to build a hydro-

electric plant in a third country, C. Assume further that both will pay an income tax to C, but that their respective countries of residence differ in that A provides a credit for foreign taxes while B does not. As a consequence, the firm from the latter country must either offer a higher bid than the other firm, thereby affecting the former's competitive position, or take a lower profit—a prospect which may lead it not to bid at all.

The foregoing is another way of saying that harmonization of *indirect* taxes will not actually equalize tax burdens suffered by international traffic. Equality of *tax* burdens will be achieved only if all taxes are harmonized, but even this would lead to *ultimate* equality of the burden borne by international trade participants only if all other factors are equalized, including national incomes (in general and per capita), the percentage of national income absorbed by tax revenues, and services rendered by the member nations to residents and business interests. Comparison and harmonization of total tax burdens is less significant as long as differences exist in services provided by the member nations, wherein residents of one pay for services of a type which residents of another enjoy at the expense of the nation.

The difficulty of establishing one economic community out of member nations which have diverse interests is obvious enough. And this is also true in the tax area, since, as before stated, the internal tax philosophy of each member nation depends largely on its own economic and social circumstances. Because the totality of its ensuing tax structure affects competitive conditions, it seems illogical to distinguish between taxes. Yet such a distinction is the underlying premise indulged in by those who argue in support of a system which relies upon a refund of *indirect* taxes at the point of export, with a compensatory tax being imposed at the point of import. *Inter alia*, this fails to accommodate differences in the *direct* tax burden borne by products.

One solution—highly theoretical—would be to refund direct as well as indirect taxes at the point of export, compensatory taxes being levied at the point of import. The practical difficulty of implementation is obvious and almost insurmountable.

A more practical *and* logical solution would call for abolition of the refund system in recognition of the fact that all taxes of a given member nation are inter-locked and determine *together* the tax burden borne by a product. This proposed solution is gaining increasing support.

This does not necessarily mean, however, that there will be, or need be, great diversity in all tax rules. Many tax problems lend themselves to a common solution, such as the matter of stock valuation, depreciation methods, loss carry-forwards, and, in the field of turnover taxes, the question of whether a multiple stage system is to be preferred over a single tax. These differences are largely responsible for the difficulty one encounters in trying to compare tax burdens. It is also more feasible to obtain uniformity in these respects than with reference to total tax rates.

While changes of the type noted are feasible, the likelihood that uniformity of this type will be achieved in the near future is quite another question. Each country would be forced to complicate its amending process by consulting with five other countries before effecting changes. All too often, this is not done for internally valid reasons. On the other hand, there is in fact some tendency toward greater uniformity. For example, France's adoption in 1948 of the *Impôt sur les Sociétés* (corporation income tax) was a step in the direction of those income taxes imposed by Germany, Luxembourg, and the Netherlands.¹ Again, the French tax reform in late

¹ Tax Reform Bill No. 6,000, dated July 27, 1960 and now pending in the Dutch Parliament, would make a few rather substantial changes in the tax pattern of that country, as it affects corporations.

The most important change involves a proposal to discriminate in favor of distributed profits. While the present temporarily increased rate of 47% (regular rate, 43%) would continue to apply to undistributed profits, a reduced rate of 32% (or 28% if the Netherlands returns to its regular rate schedule) would be applied to distributed profits. Subsidiaries which distribute profits to a parent would also enjoy the lower rate, though the parent, if Dutch, would suffer an additional 15% levy if it did not immediately re-distribute the profit. This 15% surcharge would not apply, however, to a *foreign* parent, for example, one domiciled in the United States. This means, if the pending legislation is adopted, that there could be a substantial difference between Dutch taxation of American *branches* (permanent establishments), on the one hand, and *subsidiaries*, on the other. The former would suffer the rate on undistributed profits (now 47%) whether or not its profits were remitted, while the subsidiary could enjoy the 32% reduced rate insofar as its profits are distributed. A quite separate factor may at some point compensate, at least in part, for this differential. The same legislation proposes to increase the Dutch *withholding* tax on dividends from the present 15% to 25%. At the moment, because of a treaty provision, even the 15% does not apply to dividends paid by an American controlled subsidiary to its U.S. parent. However, it is said that the Dutch government intends to start negotiations leading to a revision of this immunity, substituting instead, perhaps, a 10% or 15% rate, with the possibility of a distinction of some type being drawn if the subsidiary is wholly owned.

The pending legislation would also enlarge the chance that a corporate distributee would itself be immune from the regular corporate tax on dividends received from another corporation. The proposal is to allow the immunity if the distributee owns 5% or more of the distributing corporation's capital, as distinguished from the presently required 25%.

Another proposal would involve abandonment of the special tax on remuneration of corporate directors. Instead, limitations would be placed on the deduction allowed

1959, the ultimate aim being to substitute a single income tax on individuals for the previously existing multiple system (proportional tax and progressive tax), also brought the French tax structure into closer alignment with the income taxes imposed on individuals by the three previously mentioned countries. A year earlier, in 1958, the Belgian Minister of Finance announced that his country would also re-study its tax structure and that it would be desirable to adopt a system similar to that of the countries noted above.

In spite of this progress, it must be recognized that, for the reasons previously given, harmonization, which—to the foreigners who wish to trade in the Common Market—also carries with it a welcome overtone of simplification, will not take place overnight.

(c) *Harmonization through modernization of the bilateral tax treaties among Common Market countries.*—A chart in Section D of PART III, *supra*, shows the present status of the bilateral tax treaties which exist among Common Market countries. Some of these pre-date World War II and came into being before the dramatic increase, following that war, in international business activity. In certain respects, some treaties are, therefore, obsolete, as in the case of those between Germany and Italy, Belgium and France, and Belgium and the Netherlands. Others, such as those between France and Germany, and France and Italy, have been replaced by more modern versions. Belgium and Luxembourg chose, on the other hand, to supplement their earlier agreement.

This tendency toward modernization will be facilitated by two circumstances, apart from the fact that increasing business activity necessarily makes the matter one of urgent necessity.

The first such circumstance relates to the new tax systems which have been recently adopted, as explained in the preceding subtopic. It is obviously easier to enter into bilateral tax treaties where the two national tax systems coincide in terms of basic structure.

The second contributing circumstance goes beyond the Common Market itself. It relates to the work of the Fiscal Committee set up by the Organization for European Economic Cooperation, cov-

to the corporation, as follows: (1) remuneration of \$526 (Fl. 2,000) would be fully deductible; (2) the excess would be deductible only up to 50%; and (3) no deduction would be permitted for amounts in excess of \$2,630 (Fl. 10,000) per year.

In the case of individuals, instead of a variable rate, from 20% to 40%, on capital gains realized from the sale of shares of stock in corporations in which the taxpayer held a substantial interest, a flat rate of 20% would be imposed.

Finally, the withholding tax on an individual's compensation from employment will be a final levy, provided the compensation did not exceed \$1,934 (instead of the present \$1,815) and other income was not in excess of \$79 (instead of the present \$53).

ering all free European countries and with which the United States cooperates to a substantial extent. The Committee is charged with the responsibility of developing provisions which could be adopted by all member countries, thus giving rise to the first real prospect for a multilateral tax treaty.

Model tax treaties have been designed before; illustrative was one drafted by the League of Nations. While some of its provisions were incorporated in many bilateral tax treaties, a multilateral treaty did not result. There is greater hope, however, for the product of the Fiscal Committee of the O.E.E.C. The national delegations to it are composed of those senior officials in each country who normally have much to do with the preparation of their own national tax laws and with bilateral tax treaties. Each group of problems has been assigned to a working sub-committee composed of two or three delegations. The proposed texts are brought into plenary session for discussion and, if need be, amended in order to obtain unanimity at the point of adoption. Two reports, consisting of 14 provisions to which rather extended official commentaries were added, were published in 1958 and 1959. These reports recommended that each member country incorporate the articles either in their own tax laws or in bilateral tax treaties to which they were parties. The character of the competent membership of the committee, and the fact that the ultimate product resulted from negotiation, will contribute markedly to the acceptance of their work. In fact, some of the proposed articles have already been included in the newest treaties concluded by France, Germany, and the Netherlands. One can even expect that all treaties drafted in the future will be based on the Fiscal Committee's recommendations. Because of the extensive official commentaries appended to each article, interpretations are certain to be more uniform than are those associated with older bilateral arrangements. Nor is it too optimistic to believe that these recommendations will also have a harmonizing effect on the shape of national tax laws.

(d) *Illustrative effect of harmonization on American enterprises.*—Harmonization will, of course, tend to simplify the problems of those foreigners, such as American enterprises, who wish to do business in the Common Market. It will also reduce the significance of tax factors in making a choice of locale. But it may also have an adverse effect in some instances. Illustrative is the problem associated with taxes on inter-corporate dividends.

As indicated in the country-by-country survey in PART I, most

countries exempt intercorporate dividends from tax if both parent and subsidiary are residents. Even the withholding tax, if any, has been neutralized in that circumstance. Except in France and the Netherlands, however, such exemptions are not granted if the subsidiary is a nonresident corporation. Harmonization of the tax laws will certainly lead to the adoption of general exemptions in this circumstance. But the result may directly affect only the member nations; in effect, outside countries, such as the United States, may be prejudiced. This may make it desirable for an American company to have "sister" subsidiaries in the member nations. While the deemed-paid credit provisions in the American Internal Revenue Code may give adequate relief from double taxation, it may still be useful to transfer the shares of the "sister" subsidiaries to a European holding company situated within the Common Market, i.e., in a country which will not impose an income tax on incoming dividends nor, in compliance with a bilateral tax treaty with the United States, withhold tax when these are ultimately remitted to the American parent. And if this organizational structure is ultimately to be established, it may be desirable to make the necessary transfers before one encounters the knotty capital gains problem which would arise on transferring the shares to the holding company, as explained more fully in Section G of PART III.

SECTION B. FUTURE AMERICAN TAXATION OF FOREIGN INCOME

(a) *Chronology of the past: A guide to the future.*—An abbreviated chronology of the past will contribute markedly to the identification of possible statutory changes which are most likely to receive serious consideration by those responsible for fixing the American tax reaction to foreign income. Indeed, that so much of the present tax pattern reaches so far back into the past during which heavy foreign investments have been made—thus giving rise to a "vested right" type of psychology, is the most serious, and perhaps meritorious, obstacle confronting any major attempt at overall revision.

For 47 years, American industry has acted on the assumption that, through use of a foreign subsidiary, American taxation of foreign income could be deferred until such income was remitted as a dividend to the States.² For that same period of time, *form* has

² The United States has never tried to reach more than is now reached by I.R.C., § 882(b), except in the case of foreign personal holding companies. See I.R.C., § 551.

counted for much; *timing-wise*, American tax incidence on the foreign income of branches could not be so deferred.³ The effect, solely by reference to this differential, has been that one arrangement enjoyed an interest free loan of taxes denied to the other.

For a slightly shorter, but, nevertheless, a very long period—42 years, the total *ultimate* two-country tax on foreign income of American owned or controlled enterprises has been less in one frequently recurring circumstance than the tax borne by domestically earned income. This has been so whenever (a) foreign operations were conducted through a foreign subsidiary, (b) the foreign country imposed an income tax, but (c) at a lower effective rate than that of the United States. *American* concepts, relating to gross income and the deemed-paid credit, combined to make it possible for foreign income in that circumstance to enjoy both a deduction and a substantial credit for foreign income taxes;⁴ as a result, the *ultimate* total two-country effective rate on foreign income earned by an American parent's subsidiary could be as low as 45.24%, compared with 52% on domestically earned income. And because of the peculiar workings of the two concepts, American companies with subsidiaries in nations which imposed a 26% tax on the operating unit fared better, tax-wise, than those companies which situated the unit in countries which imposed 39% or 13% effective rates, or for that matter 0 or 52% rates.⁵

For 18 years, another possible difference in ultimate total tax costs has turned on whether foreign operations were conducted by the parent's own subsidiary, or through sub-subsidiaries, the difference here being attributable to the peculiar way in which the deemed-paid credit works at the two-tier foreign level as distinguished from the one-tier level.⁶ Under the best of circumstances, the total effective rate under the two-tier or sub-subsidiary foreign arrangement could drop as low as 40.18%,⁷ contrasted with 45.24% in the best possible circumstance under the one-tier foreign arrangement.

Again for that same period, the amount of American tax, standing alone, has differed by reference to the *place* where foreign income was earned. During World War II, when American trade was necessarily confined in major proportions to its own hemisphere, en-

³ I.R.C., § 61. *Peck & Co. v. Lowe*, 247 U.S. 165, 38 S. Ct. 432 (1918).

⁴ Discussed more fully in PART III, Section C, Subsection 1, *supra*.

⁵ Statement of Jay W. Glasman, Assistant to the Secretary of the Treasury, Hearings on H.R. 10859 and 10860, House Committee on Ways and Means, 86th Cong., 2d Sess. (1960) p. 3.

⁶ Originated by Rev. Act of 1942, § 131(f)(2), now as revised, I.R.C., § 902(b).

⁷ See note 5, *supra*, at 4. Discussed more fully in PART III, Section E, Subsection 2, *supra*.

actment of what is now a special deduction with respect to *foreign* income earned by a *domestic* corporation in that hemisphere—the aim being to make American companies more competitive with international businesses which are based in Europe,⁸ has meant that the business activity of American companies in, say, South America could enjoy more favorable tax treatment than American activity carried on in Europe. Assuming branch operations in both cases, the differential in American tax amounts to 14 percentage points, i.e., 38% as against 52%.⁹

For 34 years, the *concept* underlying the difference in American taxes on that kind of domestic and foreign income most frequently associated with *individuals* (earned income) has been out of harmony with one of the most significant concepts underlying the American tax differential on *corporate* domestic and foreign income. An American citizen who works abroad while a resident there for American tax purposes will *never* pay U.S. taxes on his foreign earned income even though the applicable foreign tax is substantially lower than would be the American tax, and this immunity may be enjoyed though the nonresident citizen ultimately remits a substantial part of his earnings to the States.¹⁰ By way of contrast, an American corporation's foreign income, even when earned by a foreign (i.e., nonresident) subsidiary, will always be taxed upon remission to the States as a dividend, assuming, of course, that the foreign income tax was not so high as to wipe out American tax liability through operation of the credit provision.

From the above, as well as from the focus of recent congressional inquiries, it appears that two different two-part problems are most likely to attract the attention of future sessions of Congress. The first involves the question of whether foreign income should enjoy a lower total effective tax rate than domestically earned income, and if there is to be such a differential, to what extent should it turn on the matter of form. The second concerns the extent to which the American tax should be deferred until foreign income is remitted to the United States, as well as the complementary question of whether form should also make a difference here. While the degree and direction of congressional concern with respect to these two basic problems will be considered under separate sub-topics below, other questions which only recently have been resolved by Congress should be noted here.

⁸ S. Rep. No. 1631, 77th Cong., 2d Sess. 32, 111 (1942).

⁹ I.R.C., §§ 921 and 922.

¹⁰ I.R.C., § 911(a), discussed more fully in PART V, Section C, *supra*, originated with Rev. Act of 1926, § 213(b) (14).

In late 1960, Congress sought in three different respects to minimize the significance of differences which had previously turned on the form of organization. First, it authorized even those American corporations which operated abroad through "sister" facilities to elect to submit their foreign tax credit to an "overall" limitation,¹¹ rather than to the previously applicable "per-country" limitation.¹² Because of the way the per-country limitation itself had been construed, other forms of organization—such as foreign holding company arrangements—had always enjoyed the averaging effect associated with the overall limitation.¹³ While this new legislation did whittle down the effect of a difference which previously had turned solely on form, certain practical differences, as noted elsewhere, do remain.¹⁴ Second, Congress also adopted legislation which clearly established the right of the government to obtain from domestic parents certain types of information relative to their foreign subsidiaries and sub-subsidiaries, which information the Treasury had always had the clear right to obtain with reference to foreign branches.¹⁵ In this same connection, it also extended to stockholders, officers, and directors a responsibility to file information returns with reference to the creation or reorganization of foreign corporations with which they were associated.¹⁶ Third and finally, it also extended the 85% dividends received deduction to American parent corporations with respect to dividends paid by a foreign corporation out of earnings and profits accumulated by the foreign facility at an *earlier* time when it was actually incorporated in the United States, i.e., before the enterprise was converted into a foreign corporation through a tax-free reorganization.¹⁷

(b) *Prospect for reduction in American taxes re income earned in the Common Market.*—As a practical matter, it seems unlikely, in the foreseeable future, that the present ultimate American

¹¹ Pub. Law 86-780, 86th Cong., 2d Sess. (1960). The ramifications pertaining to the election are discussed more fully in Section F, PART III, *supra*.

¹² A detailed discussion of the per-country limitation appears in Subsection 1 of Section C, PART III, *supra*.

¹³ Discussed more fully in Sections F and G, PART III, *supra*.

¹⁴ *Id.*

¹⁵ Pub. Law 86-780, 86th Cong., 2d Sess. (1960), adding a new § 6038 to the Code, the old § 6038 being renumbered § 6039. Included in that which must be submitted is information regarding accumulated profits, balance sheets, and certain inter-company transactions.

¹⁶ Pub. Law 86-780, 86th Cong., 2d Sess. (1960), amending I.R.C., § 6046. Formerly, only those who advised with reference to the creation or reorganization of foreign corporations had to furnish such information. This proved to be relatively ineffective, because attorneys apparently felt their advice was protected by the attorney-client relationship.

¹⁷ Pub. Law 86-779, 86th Cong., 2d Sess. (1960), amending I.R.C., § 243.

tax load borne by income derived from the Common Market will be changed.

In the past, the United States has tried three of the four ways by which the ultimate American tax on foreign income could be *reduced* to a point below that borne by domestic income. The first, a reduction in rates for domestic Western Hemisphere Trade Corporations,¹⁸ gave way to the second, a deduction of equivalent proportions for the same beneficiary.¹⁹ Policy makers in the Treasury Department have made it abundantly clear that they oppose extension of this type of benefit to investment operations even in underdeveloped foreign countries, to say nothing of extending such to the more industrialized communities of Western Europe.²⁰

Spokesmen for the Department start from the premise that rate discrimination between foreign and domestic income cannot be justified on grounds of tax policy; it must be justified, if at all, by reference to the requirements of foreign economic policy—a matter dictated in the end by foreign political policy.²¹ And while clearly interested in an expansion of investments in the under-developed part of the world, they have expressed doubt as to whether rate reduction for income from those less fortunate areas would actually constitute a significant incentive, facilitating expansion of American investments in those areas.²² As to the highly developed parts of the world, additional “special stimulus” of this type was not thought, in any event, to be a requisite of America’s foreign economic policy.²³ Coupled with the foregoing philosophy was a banker’s point of view, to the effect that the Treasury was not prepared to accept the annual revenue loss of \$200,000,000 which would follow extension of the Western Hemisphere Trade Corporation concept to the rest of the world.²⁴

Perhaps it was these same considerations, plus Treasury opposition, that led appropriate congressional committees to eliminate from bills pending in the 1960 session any extension of the Western Hemisphere Corporation tax reduction formula.²⁵

¹⁸ The reduction involved an exemption from surtax. Rev. Act of 1942, § 15(b).

¹⁹ I.R.C., § 921. Indeed, for a short time a credit was also involved, Rev. Act of 1950, § 121(c) amending I.R.C. (1939), § 15(a).

²⁰ Letter from the Secretary of the Treasury to the Chairman of the House Committee on Ways and Means, May 6, 1959, in '59 Vol. 6 CCH para. 6469. See also note 5, *supra*.

²¹ *Ibid*.

²² *Ibid*.

²³ See Secretary Anderson’s letter, note 20, *supra*.

²⁴ Note 20, *supra*.

²⁵ § 4 of the originally proposed Foreign Investment Incentive Tax Act of 1959

On the other hand, the President as well as the Treasury have indicated agreement in principle with a third method of reducing taxes on foreign income, i.e., the so-called "*tax-sparing*" arrangement.²⁶ Under present American law, a reduction by a foreign country of its own tax rates is advantageous to an American company only as long as its profits are reinvested in that country, and this only if the business is conducted through a foreign subsidiary; otherwise, in terms of ultimate effect, it serves only to reduce the credit which the American company would otherwise apply against its American tax liability. The so-called tax-sparing principle would allow a credit for income taxes specifically *waived* by a foreign country as an inducement to investment. While the Treasury agrees that the American tax pattern should not always have a negative effect on the desire of a foreign country to make special reductions in its own tax load as a means to attract American capital, the Treasury is not prepared to accept any such program on "an unlimited and unilateral basis."²⁷ In other words, it believes that tax-sparing "should be implemented on a *selective* basis either by *treaties* or by negotiated *agreements* authorized by statute."²⁸ This is probably another way of saying, *inter alia*, that the program should not be extended to the industrialized Common Market even in the unlikely event that area manifested an interest in the kind of tax sacrifice and local discrimination which such a program envisages; instead the focal point would be on the under-developed parts of the world, with the tax-sparing principle applied there only to the extent and in the manner deemed to be in accordance with the requirements of American economic policy. In the face of these considerations and Treasury opposition, here too congressional committees eliminated from pending bills of the 1960 session any reference to the tax-sparing principle.²⁹

As previously indicated, a fourth method by which foreign income will actually enjoy an effective rate advantage over domestic income relates to the combined effect of the gross income and deemed-paid credit concepts, wherein income earned through a foreign subsidiary

(H.R. 5) does not now appear in the 1960 version approved by H. Rep. No. 1282, 86th Cong., 2d Sess. (1960).

²⁶ The President's original proposal in his Budget message of 1954 is still supported in principle by the Secretary's letter, note 20, *supra*.

²⁷ See the Secretary's letter, note 20, *supra*.

²⁸ *Ibid*.

²⁹ § 6 of the originally proposed Foreign Incentive Tax Act of 1959 (H.R. 5) does not now appear in the 1960 version approved by H. Rep. No. 1282, 86th Cong., 2d Sess. (1960).

arrangement in effect enjoys both a deduction and a substantial credit for foreign income taxes.³⁰ The fact that a similar rate advantage is not available to branch operations obviously indicates considerable stress on form. Also, the fact that the ultimate preference available to a foreign subsidiary's foreign income springs from the operation of the gross income and credit concepts, rather than via a uniform rate reduction, means that the degree of preference will in fact depend "upon and fluctuate with the level and changes in tax rates abroad on a country-by-country basis. . . ." ³¹ For these reasons, the Treasury has publicly recognized that if preference is to be given because—according to its underlying premise—of the requirements of *America's* foreign economic policy, "it would appear more sound and equitable that it be granted on a uniform and predictable basis." ³² Looking at the matter solely in terms of *tax principles*, the Treasury thought (1) that the combined deduction and credit which the subsidiary arrangement enjoyed with reference to foreign income could not be defended, and (2) that it would be more appropriate to "gross up" the parent's dividend by the amount of foreign income taxes, a *full* credit then being allowed for those same taxes, assuming a distribution of all of the foreign profit. In other words, laying aside the question of possible differences in timing, the foreign income of branch and subsidiary arrangements should be taxed alike in terms of *ultimate* effect. But at this point the Treasury found itself in a dilemma.

On the one hand, the Treasury fully recognized that adoption of the "gross up" arrangement, without a compensating rate reduction for subsidiary operations, would result in a \$46,000,000 tax increase ³³ with respect to the latter through elimination of a preference which such arrangements had enjoyed for 42 years. On the other hand, extension of any such wholesale rate reduction to branches would constitute an additional inroad (1) on its underlying philosophy, namely, that preference for foreign income, over domestic income, could be justified only by reference to the needs of foreign economic policy, (2) on its factual premise, namely, a doubt that rate reduction would really stimulate foreign investments in any significant sense, and (3) on its conclusion that, in any event,

³⁰ There are those who deny that this is a "fair" way of describing the effect. Statement of Clayton E. Turney, representing the National Foreign Trade Council, Inc., Hearings on H.R. 10859 and 10860, House Committee on Ways and Means, 86th Cong., 2d Sess. (1960) p. 31 at 32.

³¹ Note 5, *supra*, at 8.

³² *Ibid.*

³³ *Id.* at 7.

investments in industrialized foreign markets did not need a further special stimulus. Nor was the Treasury prepared to accept the revenue loss which extension of a rate reduction to branches would involve. In this connection, to be wholly fair to the "vested right" psychology of subsidiary arrangements in the sense of avoiding prejudice to any, it would have been necessary to effect a reduction equal to the maximum advantage presently enjoyed by any such arrangements, namely, by those in relatively low income tax countries.

While the House Ways and Means Committee indicated at one point that it was prepared to adopt the "gross up" formula so as to put branches and subsidiaries on a par,³⁴ reconsideration leading to additional hearings in April, 1960 has led the committee to withhold, to date, reporting out a bill which would have accomplished that end.³⁵ Indeed, in at least one sense it has moved in the opposite direction in that it has reported out a bill³⁶ which is actually designed to enhance the feasibility of resorting to the advantageous multiple tier sub-subsidiary arrangement, this being the setting in which the combined exclusion and credit have the most exaggerated effect.

In this latter connection, the deemed-paid credit, when first extended twenty-eight years ago to embrace a sub-subsidiary's foreign taxes, was available only if the top tier foreign subsidiary owned "all the voting stock (except qualifying shares)" of the sub-subsidiary.³⁷ Eight years later, in 1950, business urged that the Point 4 Program would be furthered if Congress relaxed all of the ownership requirements associated with the deemed-paid credit.³⁸ Reduction in the proportionate interest which the parent had to hold in the top tier foreign subsidiary, to 10%,³⁹ was accompanied by reducing to 50% the interest which that subsidiary had to hold in a sub-subsidiary,⁴⁰ the overall aim being to accommodate those cases where ownership of the subsidiary and sub-subsidiary was divided for any number of reasons, including requirements of foreign law.⁴¹ Indeed, it was then asserted that the 50% limitation at the second tier level was retained only for administrative rea-

³⁴ For a statement regarding the sequence of events, see note 5, *supra*, at 4.

³⁵ H.R. 10859 and 10860, 86th Cong., 2d Sess. (1960).

³⁶ H.R. 11,681, 86th Cong., 2d Sess. (1960).

³⁷ Rev. Act of 1942, § 131(f)(2).

³⁸ See statement of Mitchell B. Carroll, Hearings, Committee on Ways and Means. 81st Cong., 2d Sess. (1950) Vol. 3, 623 at 626.

³⁹ Rev. Act of 1951, § 332(a), now I.R.C., § 902(a).

⁴⁰ Rev. Act of 1951, § 332(b), now I.R.C., § 902(b).

⁴¹ S. Rep. No. 781, 82d Cong., 1st Sess. 55 (1951).

sons,⁴² the general belief being expressed that the amount of ultimate dividends received by the parent would be affected by foreign income taxes irrespective of the proportion of ownership.⁴³ In late 1960, the House committee reported out a bill⁴⁴ which would downgrade the required ownership at the second tier level to 20%, arguing again that divided ownership cases should be accommodated subject only to limitations geared to administrative feasibility which now, it believed, would be "fully" provided for by a 20% standard.⁴⁵ While the House itself approved the proposal,⁴⁶ the Senate did not have an opportunity to act on the matter in the 1960 session. The support which the proposal enjoyed in the House suggests, however, that the matter is almost certain to be considered again in the 1961 session.

(c) *Prospect for a consistent pattern re deferral of American tax on foreign income.*—As also noted in sub-topic (a), *supra*, the most striking and practical difference between an operation conducted through a foreign subsidiary and that handled by a branch involves the opportunity, in the case of the former only, to defer American taxes on foreign income until such income is remitted to the States.

Support for deferral in the case of foreign subsidiaries rests essentially on the notion that only in this way will American controlled foreign operations be placed on a competitive basis with foreign controlled enterprises with which they compete.⁴⁷ It has also been said that the deferral should terminate when dividends are distributed to the parent at which time the foreign profits enter the domestic market.⁴⁸

The same general theory is obviously just as applicable to a branch operation as to a foreign subsidiary. Even the Treasury has acknowledged that the stress placed on form by existing law is hard to justify on the merits⁴⁹ though, of course, the problem itself cannot be dealt with separate and apart from such intimately related matters as the difference between the applicable direct and deemed-paid credit provisions. Nevertheless, the Treasury has opposed

⁴² The character of the administrative difficulties and the reasons why 50% became the magic number were not discussed.

⁴³ Note 41, *supra*.

⁴⁴ H.R. 11,681, 86th Cong., 2d Sess. (1960).

⁴⁵ H. Rep. No. 2100, 86th Cong., 2d Sess. 3 (1960).

⁴⁶ S. Rep. No. 781, 82d Cong., 1st Sess. 41 (1951).

⁴⁷ H. Rep. No. 1282, 86th Cong., 2d Sess. 1 (1960).

⁴⁸ *Id.* at 2.

⁴⁹ See Secretary's letter, note 20, *supra*.

wholesale extension of the deferral privilege to branch operations in general, noting that the revenue loss would run between \$300,000,000 and \$500,000,000, and would amount at least to \$100,000,000 even if export situations were denied the privilege.⁵⁰ On the other hand, the Treasury has voiced approval of a more limited solution to the differential, namely, allowance of the deferral privilege to a new type of domestic tax entity, to be called a "foreign business corporation," the business activities of which would be centralized in the *under-developed* nations.⁵¹

The House Committee on Ways and Means was not originally content, however, with so limited an approach. H.R. 5, as approved by that committee in the current session,⁵² would have extended the deferral privilege to an electing *domestic* corporation (then to be known as a "foreign business corporation" or FBC) *without* limitation by reference to the *place* from which its foreign source income was derived.

That committee apparently believed its more sweeping approach would in fact accomplish in large measure the Treasury's aim of expanding investments in under-developed areas; for the most part, those were the areas, according to the committee, "where the tax rates are lower than those in the United States, and it is only to the extent that the taxes on the same income are lower in the foreign countries that deferral of U.S. tax results in any benefit."⁵³ Nevertheless, the bill encountered very rough sledding in the House itself. Concern was expressed, for example, that adoption of the bill would further stimulate American industry to produce in other countries products *now* produced by American labor in the United States, thus eliminating American jobs.⁵⁴ In the end, the House committee was forced to make a substantial concession; from the floor of the House, it proposed an amendment limiting the application of the new concept to FBC's doing business in "*less developed countries*,"⁵⁵ a concept defined specifically, *inter alia*, to exclude most of Western Europe, including all Common Market nations, and such other developed countries as Canada and Japan.⁵⁶ The House then passed the amended bill by a scant three vote margin. In view

⁵⁰ *Ibid.*

⁵¹ *Ibid.*

⁵² Note 47, *supra*.

⁵³ *Id.* at 2.

⁵⁴ See debate in the House, 106 Cong. Rec. 9823 (1960).

⁵⁵ 106 Cong. Rec. 9821 (1960).

⁵⁶ *Ibid.* See also proposed § 951(e)(2) of H.R. 5, 86th Cong., 2d Sess. (1960) as transmitted to the Senate.

of that narrow margin and of the fact that the Senate Finance Committee has not yet indicated its own views with reference to the total problem, it is not worthwhile here to do more than indicate the main highlights of the House approved bill.

The House committee itself originally contemplated applying five limitations as conditions for qualification as an FBC. Some of these, as well as other restrictions bearing only on the amount which could be deferred—as distinguished from the question of qualification itself, were originally intended by the committee to be limitations on either indirect or direct American activity of such a corporation. When the committee capitulated to the demand that the bill be limited to less developed countries, the previously mentioned limitations were re-designed as restrictions on indirect or direct activity outside of the less developed countries, as distinguished from activity solely within the United States.

The five limitations, as re-designed, follow.

(1) Certain types of corporations which already enjoy some significant type of special tax benefit or treatment would be rendered ineligible, including tax-exempt organizations, China Trade Act corporations, regulated investment companies, personal holding companies, life insurance companies,⁵⁷ unincorporated business enterprises taxed as corporations under § 1361, and corporations electing to have their income taxed to shareholders under Subchapter S.⁵⁸

(2) In order to facilitate the Treasury's determination of whether a corporation qualifies as an FBC and has complied with the requirements of other tax laws, the corporation, as a condition to qualification, would have to furnish the Treasury such information as may be necessary with reference to any year which is affected by, or affects, the election.⁵⁹

(3) While an otherwise qualified domestic corporation would not in any event enjoy deferral with respect to income "from sources *without* less developed countries,"⁶⁰ qualification of the corporation as an FBC would also carry with it a requirement that its income be almost exclusively from foreign operations, i.e., 90% or more of its gross income must be from sources within less developed countries.⁶¹ By way of contrast, deferral of the Amer-

⁵⁷ Life insurance companies were excluded until the matter could be given further study. Note 47, *supra*, at 4.

⁵⁸ Proposed § 951(a)(4).

⁵⁹ Proposed § 951(a)(5).

⁶⁰ Proposed § 952(a)(1)(A).

⁶¹ Proposed § 951(a)(1).

ican tax on a *foreign* subsidiary's *foreign* profit is not lost even if it derives substantial income from American sources.

(4) Qualification would also be denied if the corporation derived more than 10% of its gross income from the sale of any articles for ultimate use, consumption, or disposition in the United States.⁶² This limitation rests on a notion which is not applied to foreign subsidiaries, namely, that deferral even with respect to a company's *foreign* source profit is unwarranted if a significant part of its products are "in competition with domestically produced or extracted products where this tax deferral is not available."⁶³

(5) In order to "restrict the benefits of tax deferral largely to an *active* business enterprise or to a corporation receiving income from such a corporation,"⁶⁴ qualification was also made dependent upon a requirement that 90% or more of the corporation's gross income be from some combination of three specified classes of income:⁶⁵ (a) income from the active conduct of a trade or business; (b) dividends or other income from a qualified payor corporation, i.e., from a corporation in which the FBC itself held a 10% stock ownership and which met substantially the same qualifications as the FBC itself;⁶⁶ and (c) compensation for technical, managerial, engineering, construction, scientific, or like services performed in less developed countries and for the right to use, in less developed countries, patents, copyrights, secret processes and formulas, goodwill, trademarks, trade brands, franchises, and other like properties. A royalty from patents, etc., but not income from services rendered abroad, is closely akin in many circumstances to *passive* income as distinguished from that derived from the active conduct of a trade or business. Accordingly, except where it does involve such active conduct or is income other than dividends from a qualified payor corporation, the royalty income could not be taken into account in meeting the 90% test to the extent it exceeds 25% of the corporation's gross income.⁶⁷ Illustratively, if all of the corporation's income would have qualified under the 90% test except for the fact that 45% was derived from royalties, the corporation would not qualify,

⁶² Proposed § 951(a)(3).

⁶³ Note 47, *supra*, at 4.

⁶⁴ *Id.* at 3. Italics added.

⁶⁵ Proposed § 951(a)(2).

⁶⁶ The dividend must be out of earnings and profits of such a corporation when it was a qualified payor corporation or would have been except for the 10% stock ownership requirement.

⁶⁷ Proposed § 951(a)(2)(D)(ii). See also note 47, *supra*, at 4.

for only 80% of its gross would be deemed to satisfy the 90% requirement.

Other limitations, while *not* conditions to qualification, would also be imposed as a means of denying deferral to the extent foreign income was actually attributable to business activity in other than less developed countries. To appreciate the significance of the device which would be utilized to this end, one must understand the difference between the ultimate tax treatment of a *domestic* FBC and that currently associated with foreign profits earned by a *foreign* subsidiary.

Whereas the United States taxes the latter's profit only to the domestic *parent*, and then only to the extent of dividends received—with an appropriate credit for foreign income taxes, the proposal regarding an FBC contemplates that *it* will be the taxable entity,⁶⁸ the timing to coincide with any *actual or constructive* distribution,⁶⁹ and if to a parent, the latter would normally enjoy what is equivalent to a 100% dividends received deduction.⁷⁰ Loans from an FBC to a parent holding 10% or more stock ownership would be deemed, illustratively, a constructive distribution,⁷¹ the theory being that the parent "has effectively achieved the withdrawal of the funds from the foreign operation and made them available for its own operations."⁷²

Moreover, in keeping with the previously stated purpose of denying deferral to the extent foreign income was actually attributable to business activity in other than the less developed countries, a formula, involving the ratio of investments and payroll in the less developed countries to *total* investments and payroll wherever located, is to be applied to the active trade or business income from less developed countries for the purpose of denying deferral to that portion actually attributable to activity based elsewhere.⁷³ In determining the ratio, the significance of inventory would be neutralized; the investment factor would include only real property and tangible personal property (other than inventory) of a type ordinary and necessary to the operation of the business, all such property being

⁶⁸ Proposed § 952.

⁶⁹ Proposed §§ 953 and 954. "Distribution" would include redemptions and liquidations.

⁷⁰ § 2(b) of H.R. 5 would amend I.R.C., § 243 to this effect.

⁷¹ Proposed § 954(d).

⁷² Note 47, *supra*, at 12. However, loans from a subsidiary to an FBC will not result immediately in a U.S. tax though it will increase the FBC's reinvested foreign income. Proposed § 954(d).

⁷³ Proposed § 954(b).

valued for this purpose by reference to the adjusted basis. The payroll factor, geared also to ordinary and necessary items, would be given double weight. But only one-half of the product resulting from multiplication of the ratio by active business income from less developed countries would be deemed *constructively* distributed, but not—according to a *de minimus* rule—if the factors outside the less developed countries are less than 10%.

When the taxpayer is engaged in two or more separate trades or businesses, the ratio would be applied separately, provided the trades or businesses are “clearly and distinctly separate.”⁷⁴

Also deemed constructively distributed from foreign income otherwise previously or currently deferred (“reinvested foreign income account”) are those amounts invested in so-called “prohibited property,”⁷⁵ another notion which is *inapplicable* to the more free-wheeling ordinary foreign subsidiary type of arrangement. The aim of this restriction is to limit deferral to those cases where the funds are being used in *active foreign* operations, i.e., to deny deferral to the extent the funds (1) have been diverted, directly or indirectly, to operations outside of less well developed countries, or (2) with certain exceptions, have been converted into *mere* investments, whether foreign or American. The description of the prohibited class is accomplished by identifying nonprohibited properties, which would include the following: (1) tangible or intangible property which is ordinary and necessary for carrying on a trade or business, but only where 90% of the total income for the current or preceding year is derived from less developed countries; (2) securities of a “qualified payor corporation” or of another 10% owned FBC (including one not qualifying for the current year, provided it has elected FBC treatment); (3) bonds, etc., of foreign governments not in excess of 15% of the corporation’s earnings and profits accumulated since 1960; (4) bonds, etc., of the United States; (5) money; (6) bank deposits; and (7) loans to a parent holding 10% stock ownership. Loans were excluded from the prohibited class because of the previously described separate treatment applicable to them.⁷⁶

Wholly apart from the action of the House in restricting the benefits of this bill to those enterprises doing business in the “less developed countries,” it appears from the foregoing that the oppor-

⁷⁴ Note 47, *supra*, at 11.

⁷⁵ Proposed § 954(c).

⁷⁶ Note 47, *supra*, at 11.

tunity to defer American tax through an FBC would suffer from restrictions not applicable to an ordinary foreign subsidiary arrangement. There will also be a difference between the two arrangements in the *ultimate* amount of American tax if the FBC must "gross up" the amount includible by adding the applicable amount of foreign taxes, a full credit then being allowed for the latter, while a foreign subsidiary arrangement remains free of the "gross up" requirement, thus enjoying what is tantamount to a deduction *and* a substantial credit for the foreign tax.

While H.R. 5 (the proposed FBC legislation), as originally approved by the House committee, called for the application of a "gross up" requirement in both cases, that notion, as applied to ordinary foreign subsidiary arrangements, was carved out for special consideration in the separate legislation mentioned in subtopic (b) above. An ultimate difference between the two would survive if, on the one hand, that special bill should fail of adoption and, on the other, the House committee continued to insist, as it did in the original version of H.R. 5, that deferral for an FBC should not "decrease the ultimate level of combined foreign and U.S. tax on . . . foreign income of these domestic corporations below the level of taxation generally applicable to other domestic corporations operating abroad through branches."⁷⁷ However, in the final House debate regarding H.R. 5 (FBC legislation), its sponsor noted that the House committee had not yet resolved the separate "gross up" question as it related to *foreign* subsidiaries and proceeded to suggest that the committee felt that "whatever is done should apply across the board. . . ."

Laying aside the ultimate result with reference to that question, there may be some companies which would prefer an FBC arrangement, using either branches abroad or using the FBC as a holding company to own stock in qualified foreign subsidiaries. In the absence of special mitigation, those with foreign interests otherwise presently organized might have encountered a tax at the point when interests are reshuffled so as to make use of an FBC. With reference to companies interested in converting foreign subsidiary operations into branches of an FBC, H.R. 5 takes account of the prospect that the Treasury, by reliance on § 367, might have called for recognition of gain when business property of the foreign subsidiary is transferred to an FBC. The bill specifically neutralizes § 367 in this case, provided substantially all of the property of the foreign sub-

⁷⁷ *Id.* at 2.

subsidiary is so transferred. But in such case, the accumulated earnings and profits of the foreign subsidiary pass into the reinvested foreign income account (deferred income account) of the FBC and would, upon distribution, be taxed to it.⁷⁸ It was not thought that nonrecognition should be enjoyed and deferral obtained with reference to increments which took place in the value of inventory while held in the United States prior to the transfer. Accordingly, H.R. 5 would add a new section to the Code calling for inclusion in gross income of any gain realized when such property is transferred to an FBC or to a foreign subsidiary.⁷⁹

Under certain conditions, H.R. 5 also neutralizes § 367 in that instance where an FBC is converted into a holding company through transfer of "foreign business property" to a *foreign* subsidiary.⁸⁰ But this will be so only if the FBC (holding company) owns 80% of the voting stock as well as 80% of all other classes of stock in the subsidiary. Moreover, the foreign subsidiary must be a "qualified payor corporation," i.e., it must in general meet the standards otherwise applicable to the FBC itself. Illustratively, its income must be derived, to the extent of 90%, from less developed countries. Again, 90% or more of its income must be derived from articles which are not imported into the United States.

Finally, but only in a fairly limited type of case, H.R. 5 would also neutralize the possibility, under § 1491, that the Treasury might apply an excise tax in that instance where an FBC transfers stock in one foreign subsidiary to another, thereby creating a three tier chain.⁸¹ The tax will not be applied if (1) the transferor satisfies the previously described control test, (2) the subsidiary, the stock of which is transferred, measures up to the previously described "qualified payor corporation" as to the transferor for the 3 preceding taxable years, and for the first subsequent taxable year, (a) will be such as to the transferee, and (b) will derive 50% or more of its gross income from less developed countries and from the active conduct of a trade or business.

⁷⁸ § 3(a).

⁷⁹ § 3(c) proposes addition of a new § 78 to the Code.

⁸⁰ Proposed § 367(c). Under certain conditions, § 2(d) of H.R. 5 would also immunize an F.B.C. from the personal holding company provisions by amending I.R.C., § 543.

⁸¹ § 3(b).

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Chapter XII

The Association of the Overseas Countries and Territories

Peter Hay

I. INTRODUCTION

Four of the E.E.C. Member States have administered overseas dependencies which exceed their mother countries in area. The size and potential of the territories which have been associated with France are, in particular, often vastly underestimated. Former French West Africa alone is, for example, four times larger than the Europe of the Six; if its map were superimposed on that of Europe, its boundaries would run through Brest, Liverpool, Oslo, Warsaw, Moscow, Bucharest, Athens, Rome, and Barcelona. The examples could be multiplied: for instance, the former Belgian Congo is 80 times larger than Belgium and Dutch New Guinea 13 times larger than the Netherlands. These present and former overseas dependencies are together almost 10 times larger than the Europe of the Six and exceed the size of the United States by more than one-third, although their aggregate population of 55 million amounts (roughly) to only one-third that of the Six. Indeed, the vastness, the difficulty of access, and the climate of the African territories justifies the epithet of the Roman geographer, "Africa protentosa."¹

The idea of European cooperation with the African territories received its first formal impetus in a Recommendation adopted by the Council of Europe on September 25, 1952, the "Strasbourg-Plan."² The Recommendation was designed to promote trade relations and to assist the territories in their efforts to develop. Yet the Messina Declaration of 1955, charging the intergovernmental

¹ Beaulieu, *Les Investissements dans les Pays et Territoires d'Outre-Mer Associés à la C.E.E., Politique Générale et Méthodes*, 1958 REVUE DU MARCHÉ COMMUN 391, 392.

² Cf. O.E.E.C., COMMENTS ON THE STRASBOURG PLAN (1954).

committee under the chairmanship of M. Spaak with the task of drawing up a report on a European community, omitted any reference to the overseas territories. The question was not raised until November 1956 and was solved barely a month before the Treaty was signed in March 1957 by a special meeting of the heads of government.³

The need for some sort of arrangement concerning the overseas territories arose mainly because of the special position of France. France felt that she could not grant economic concessions to her European partners and, at the same time, maintain a costly development program for her overseas territories. She therefore felt Community assistance was needed.

On the other hand, France found herself in a position akin to that of the United Kingdom in the negotiations for a Free Trade Area. She had existing economic commitments to her overseas territories—for instance, a customs union with French West Africa—to which was now to be added a customs union with her European partners. As a result France felt that she was being forced to choose between “divorce” and “bigamy” with regard to her overseas relations.⁴ A third choice, automatic extension of the E.E.C. Treaty to the overseas territories, met with opposition, particularly that of Germany, which hesitated to undertake new overseas commitments having long been free of them.⁵ A compromise solution was therefore reached whereby the territories were to be “associated” with the Community.

The territories are, for purposes of association, divided into three groups: (1) those which are constitutionally a part of their metropolitan countries (for example, the overseas department of Réunion); (2) those which are dependent overseas countries (for example, the Republic of Mauritania); and (3) independent countries which have special relations with France (Tunisia and Morocco) and Italy (Libya), as well as the autonomous parts of the Netherlands (Surinam and Antilles). Association is qualitatively different for each of the first two groups in regard to such matters as trade barriers, right of establishment, movement of workers, and availability of investment funds from the specially created over-

³ Germany, Bundesrat, *Niederschrift über die Sitzung des Sonderausschusses “Gemeinsamer Markt und Euratom” vom 24. April 1957*, 4.

⁴ Leduc, *L’Association des Pays d’Outre-Mer*, 1958 *REVUE D’ÉCONOMIE POLITIQUE* 198, 199, referring to MOUSSA, *LES CHANCES ÉCONOMIQUES DE LA COMMUNAUTÉ FRANCO-AFRICAINNE*, 193–195 (1957).

⁵ Germany, Bundestag, *Schriftlicher Bericht des 3. Sonderausschusses-Gemeinsamer Markt/Euratom*, Drucksache 3660, 56 (1957).

seas Development Fund. The third group is invited to negotiate for association.

Association is of obvious political importance in the struggle for the friendship of the uncommitted nations.⁶ This and the economic significance of close ties between these producers of primary products and industrial Western Europe account for the lively discussion the association has already sparked both in the United Nations and in G.A.T.T.

Association of the overseas territories with the E.E.C. is of immediate relevance to only a limited group of American businesses—for example, to the extractive industries (such as mining and the oil industry) and to American agricultural (coffee and banana) interests in South America—which will be affected by African competition in the European market. As association becomes a reality, however, business opportunities for a larger group of American enterprises may develop. The territories may eventually offer opportunities for the investment of development capital and for the establishment of companies using local raw materials and manufacturing for local consumption and export to European or other markets.

The purpose of this chapter is to outline the legal status of the territories, the relevant provisions of the Treaty, and some of the legal and economic problems which association creates. The discussion will center mainly on the African territories since they make up the most important area covered by the association provisions, and it will give substantial attention to agricultural problems in contrast to other chapters in this book. The rapid changes taking place on the African Continent necessarily mean that parts of the discussion are tentative.

II. THE POLITICAL AND ECONOMIC STATUS OF THE TERRITORIES

A careful distinction between the different uses of the word “territories” must be made at the outset. When the reference is in a generic, collective sense, this chapter will refer to “territories.” On the other hand, the term “Overseas Territories” will be used to denote those of the “territories” which are not, constitutionally, a

⁶ Germany, Bundesrat, *supra* note 3 at 38; also commentary by Fischer-Menshausen, in VON DER GROEBEN and VON BOECKH (editors), *HANDBUCH FÜR EUROPÄISCHE WIRTSCHAFT* (hereinafter cited as *HANDBUCH*) IA 59, 4.

part of their metropolitan countries (as are overseas departments of France, for example) and which are associated with the E.E.C. under the Implementing Convention of the Treaty.

A. THE POLITICAL RELATION TO THE METROPOLITAN COUNTRIES

1. THE OVERSEAS TERRITORIES OF FRANCE

Before the Constitution of 1958 went into effect, the French *Republic* consisted, in addition to metropolitan France including Algeria,⁷ of the overseas *departments* of Guadeloupe, Guiana, Martinique, and Réunion, of the *Overseas Territories* of French West Africa (Senegal, Mauritania, Sudan (not to be confused with the Sudan which lies south of Egypt), Guinea, Ivory Coast, Volta, Dahomey, and Niger), French Equatorial Africa (Gabon, Congo, Ubangi-Shari and Chad), Madagascar, French Somaliland, St. Pierre, and Miquelon, the Comoro Archipelago, as well as the Territories in Oceania and the Antarctic. The Republic together with the trust-territories of Togo and Cameroon made up the *French Union* which, expanded by the friendly independent states of the franc area (Tunisia, Morocco) and the Condominium of the New Hebrides, made up the *Ensemble Française*.⁸

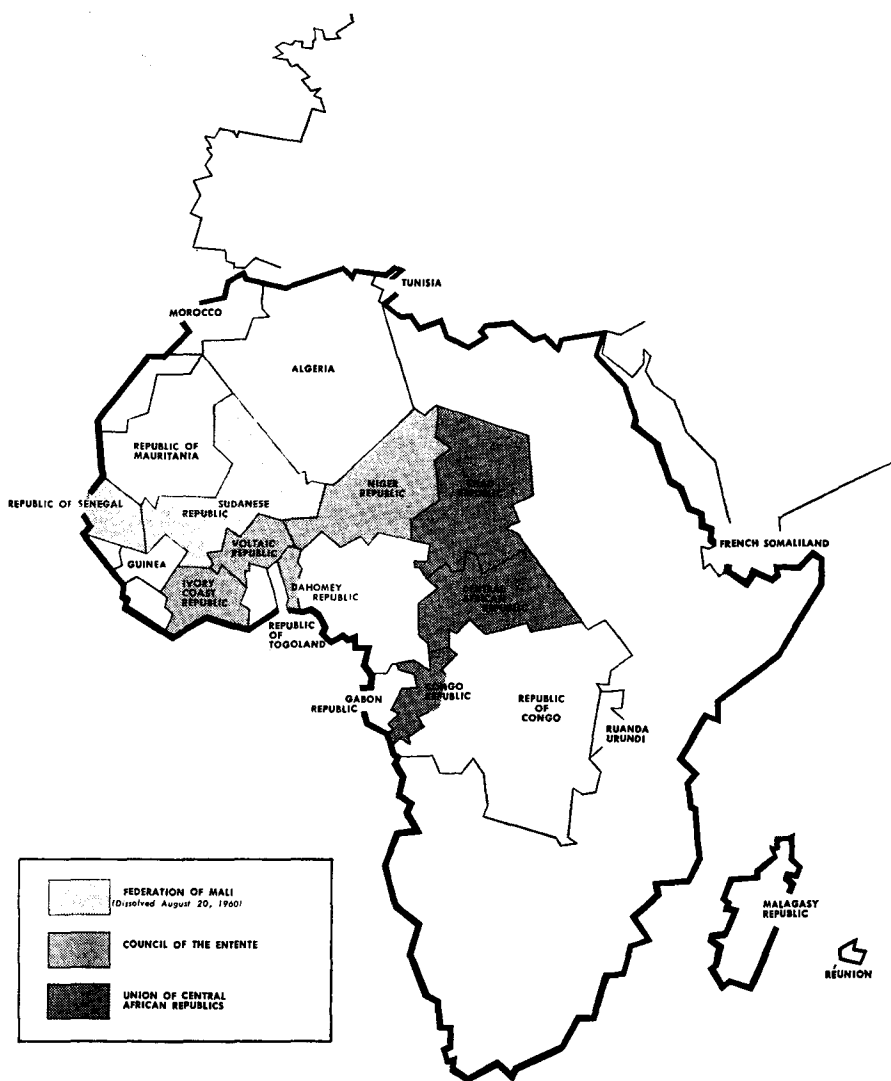
The new Constitution does not alter the relationship of France to its overseas departments, which were and are constitutionally a part of metropolitan France,⁹ to the trust territories, nor to the friendly associated states. It does, however, envision a change in France's relationship to the Overseas Territories. Even before the constitutional changes, the administration of the Overseas Territories had been liberalized. The basic law of 1956 (*loi-cadre*),¹⁰ had given them internal autonomy and to the territorial assemblies the right to elect responsible ministers to Government Councils. The Government Councils replaced the old "Great Councils" previously elected according to a class system. In July 1958 General de Gaulle transferred the chairmanship of the Government Councils from the Territorial Governors to the elected Prime Ministers.

⁷ See the discussion of the "Statut de l'Algérie" of 1947 by Naegelen, *L'Algérie*, in BERNARD et al., *LA FRANCE D'OUTRE-MER, SA SITUATION ACTUELLE*, 1 at 8 (1953).

⁸ DE LATTRE, *LA MISE EN VALEUR DE L'ENSEMBLE EURAFRICAIN FRANÇAIS ET LA PARTICIPATION DES CAPITAUX ÉTRANGERS* 167 (1954).

⁹ Constitution of 1958 arts. 72-73.

¹⁰ The *loi-cadre* of June 23, 1956 is discussed by Quermonne, 1957 *RECUEIL DALLOZ Chronique* 5; cf. also, Charpentier, *Les Lois-Cadres et la Fonction Gouvernementale*, 1958 *REVUE DU DROIT PUBLIC ET DE LA SCIENCE POLITIQUE* 220.



African Territories Associated under the E.E.C. Treaty

Not shown: (a) The former trust-territory of Italian Somaliland, which, with former British Somaliland, now composes the Republic of Somalia, extending south from the easternmost tip of the continent, and (b) the former French trust-territory Cameroon, now independent and considered associated with the E.E.C., located due west of the Central African Republic.

The constitutional referendum of 1958 left the Overseas Territories free to choose independence or membership in a "French Community." All, except Guinea, originally chose the latter. The new Constitution also leaves the Overseas Territories free to choose the form of membership in the new French Community,¹¹ and provides for a procedure by which they may gain independence at any time.¹² Their first alternative was to retain the status given them by the basic law of 1956, its implementing acts, and the Decree of 1958. In this case the Republic would continue to be responsible for external relations, defense, currency, and finances, the territorial assemblies would continue, and the governor appointed by the Republic would remain *chef du territoire*. French Somaliland, Oceania, the Comores, St. Pierre, Miquelon, and New Caledonia chose this status.¹³ Secondly, the Overseas Territories could choose to become overseas departments. The governor would then be replaced by a prefect, and legislation and administration would become identical with that of metropolitan France, except for modifications necessitated by the peculiar situation of the department.¹⁴ Finally, the Overseas Territories could choose to become member states of the French Community.

Seven Overseas Territories of French West Africa, the four Overseas Territories of French Equatorial Africa and Madagascar made this choice, and their territorial assemblies became "legislative assemblies."¹⁵ The status of a member state in the French Community requires transfer of certain powers to the Community.¹⁶ Under the Fourth Republic, these policy-making functions (in regard to foreign affairs, defense, economic, and fiscal policy and policies concerning strategic raw materials) were attributes of the Republic. In the French Community, however, France is only one of the partners, although she does enjoy some special privileges: she provides the president; she has a majority in the senate of the Community; she conducts affairs of common interest during an interim period; and she plays a rôle in the modification of the status of any member state.¹⁷ The organs of the Community are the

¹¹ Constitution of 1958 art. 76. For the changes made by the new Constitution, see Massa, *Die französische Verfassung vom 5. Oktober 1958 und die überseeischen Gebiete*, 14 EUROPA ARCHIV 109 ff. (1959), and Silvera, *Passé de l'Union française et avenir de la Communauté*, 1958 REVUE JURIDIQUE ET POLITIQUE DE L'UNION FRANÇAISE, 589 ff.

¹² Constitution of 1958 art. 86, para. 2.

¹³ Massa, *op. cit. supra* note 11, at 112; THE STATESMAN'S YEAR BOOK 1959, 997.

¹⁴ Constitution of 1958 art. 73.

¹⁵ Constitution of 1958 art. 83.

¹⁶ Constitution of 1958 art. 78.

¹⁷ Cf. Constitution of 1958 arts. 80, 83, 79, and 86.

Executive Council, presided over by the President of the Republic and attended by the heads of governments of the member states, the Senate of the Community (not to be confused with the Senate of the Republic), and the Court of Arbitration.¹⁸

Apart from the changes in their relationship to metropolitan France, French West and Equatorial Africa also underwent internal changes. Four of the seven Overseas Territories of French West Africa established the Federation of Mali in January 1959; the Voltaic and Dahomey Republics later withdrew leaving only Senegal and Sudan in the Federation.¹⁹ In August 1960 internal differences developed, resulting in the dissolution of the Federation so that Senegal and Sudan now continue as separate republics. In September 1960, Sudan changed its name to Republic of Mali. While the Ivory Coast, Niger, and Mauritania declined to join the Federation, they agreed to join in a customs union with the states of the Federation on June 6, 1959.²⁰ The Ivory Coast, Niger, Dahomey, and Voltaic Republics also entered into a loose association with each other—the Council of the Entente.²¹ The three republics of former French Equatorial Africa, the Congo—not to be confused with the Republic of the Congo on which it borders and which was formerly the Belgian Congo—, Central African (formerly Ubangi-Shari) and Chad Republics, are also grouped in the Union of Central African Republics from which the Gabon Republic has remained aloof, although she maintains close economic ties with the Union.²²

On May 11, 1960, an amendment to Articles 85 and 86 of the French Constitution took effect, which permits member states of the French Community to become independent without losing membership in the Community and independent states to become members of the French Community. Accordingly the former Mali Federation became independent on June 20, 1960; the Malagasy Republic (formerly Madagascar) on June 25, 1960. Moreover, France signed accords on July 11, 1960, pledging independence to the four republics of the Council of the Entente (the Ivory Coast, Niger, Dahomey, and Voltaic Republics) and on July 12, 1960, to the Union of Central African Republics (the Congo, Central African,

¹⁸ Constitution of 1958 arts. 80–84. For a discussion of these organs, see Massa, *op. cit. supra* note 11, at 113–114. Also see Krebs, *Die Communauté Française im Jahre 1960*, 3 EUROPÄISCHE WIRTSCHAFT 155 (1960).

¹⁹ Massa, *op. cit. supra* note 11 at 118; N.Y. Times, March 2, 1959, 2:5; March 18, 1959, 2:5; April 6, 1959, 10:4.

²⁰ New York Times, June 7, 1959, 15:2.

²¹ U.S. Department of State, Press Release No. 602, Aug. 20, 1959 at 5.

²² Massa, *op. cit. supra* note 11, at 118.

and Chad Republics). All should be independent by the time this book is published.

The Gabon Republic was also negotiating with France for independence in the summer of 1960 and it was expected that the Republic of Mauritania would have received its independence by 1961.

2. THE OVERSEAS TERRITORIES OF BELGIUM, THE NETHERLANDS, AND ITALY

The two Belgian Overseas Territories to which the Treaty originally applied were the Belgian Congo and the trust territory of Ruanda-Urundi. Since July 1, 1960, the Belgian Congo has been the independent Republic of the Congo, however, and in June 1960, Belgium informed the United Nations Trusteeship Council that she had agreed to hold elections in Ruanda-Urundi early in 1961 as a prelude to discussions by the United Nations General Assembly of independence for this Overseas Territory.

The Netherlands have three Overseas Territories, Surinam, Netherlands New Guinea, and Netherlands Antilles. Of these, the Netherlands could bind only New Guinea by signing the E.E.C. Treaty. The Statute of the Realm of 1954²³ gives Surinam and the Antilles partnership status with the Netherlands as "members of the realm." Because of this substantial autonomy, the Netherlands could not bind them with regard to the E.E.C. Treaty. A separate agreement of association must therefore be negotiated, to be approved by the Netherlands as well as by the parliamentary bodies of Surinam and the Antilles.²⁴ Italy, finally, administered the trust-territory of Italian Somaliland which became part of the independent Republic of Somalia on July 1, 1960. A special problem shared by all of the formerly dependent or trust territories is that of continued association with the E.E.C. now that they are independent.²⁵

B. ECONOMIC CONDITIONS IN THE OVERSEAS TERRITORIES

The territories in question, and most importantly those in Africa, are still in the early stages of economic development. Incomes *per*

²³ Cf. Van Panhuys, *Das Statut des Königreichs der Niederlande, in Kraft getreten am 29. Dezember 1954*, 16 ZEITSCHRIFT FÜR AUSLÄNDISCHES ÖFFENTLICHES RECHT UND VÖLKERRECHT 304 (1955/56).

²⁴ Belgium, Chambre des Représentants, *Rapport fait au nom de la Commission Spéciale*, 727 (1956-57), No. 2, 68-69.

²⁵ Leduc, *supra* note 4, at 203.

capita are low and industry is lacking. The lack of industrial resources results in a lack of investment capital and technical know-how. Large development plans have been undertaken by the metropolitan countries, although most such plans, because of the size of the task, can only be concerned with matters of "infrastructure," that is, roads, hospitals, schools, and the like.

The Netherlands pursue a policy of non-discrimination with regard to imports into New Guinea, and New Guinea exports are granted no preferential treatment in the Netherlands. On the other hand, the French Overseas Territories of the franc area together with France comprise a tightly-knit economic unit (with the exception of French Equatorial Africa which hitherto has accorded no preferences to France).²⁶ The greatest part of the foreign trade of the French Overseas Territories takes place within the franc area and at prices above the world level.

In 1956, the base year for the establishment of the E.E.C., the total value of the exports of the Overseas Territories amounted to roughly \$1.06 billion,²⁷ of which 71 percent went to the E.E.C. countries. Of all export commodities, unroasted coffee is the most important. It amounted to 17.5 percent of the value of total exports in 1956 and to 21.1 percent of total coffee imports by the E.E.C. countries. The next most important agricultural commodity is cocoa which in 1956 amounted to 4.9 percent of the value of exports. In order of importance, bananas and oil-bearing products represent the next largest percentages of agricultural exports.

The metropolitan countries have established development programs for all the Overseas Territories to raise standards of living and promote some degree of industrialization. The Second Modernization Plan for French Territories, for example, will result in contributions of nearly \$250 million annually.²⁸ In the former Belgian

²⁶ Stohler, *Afrika wird europäischer Wirtschaftspartner*, DIE ZEIT (Hamburg) May 22, 1959, 13.

²⁷ See generally, U.N. GENERAL ASSEMBLY, REPORT OF THE SECRETARIAT, *Association of non-self-governing territories with the European Economic Community*, Doc. A/3916/Rev. 1 (1958), 5 ff.

²⁸ *Ibid.*, 13-14. The annual average of "new investments" (i.e., excluding measures for the renewal of depreciated equipment and for the increase of supplies but including certain "expenses equivalent to an increase in capital") in the French territories between 1951-1953 amounted to approximately \$980 million. Doucy and Pouleur-Bouvier, *Die Beziehungen zwischen einem integrierten Europa und den überseeischen Hoheitsgebieten seiner Mitgliedsländer*, in RACINE (editor), *EUROPAS WIRTSCHAFTSEINHEIT VON MORGEN* (Heft 15 der Schriftenreihe zum Handbuch für Europäische Wirtschaft) 192 at 222 (1960). Referring to LA CROIX of April 3, 1957, Rubinsky points out that 20 out of every 100 francs of tax money in France go to "Africa." Rubinsky, *Imperialist Africa Projects*, 1957 INTERNATIONAL AFFAIRS 46 at 47 (No. 7). (Published in U.S.S.R.)

Congo, a 10-year development plan, designed mainly to finance "infrastructure" projects during the years 1948-1958 and totaling about \$1 billion went into effect.²⁹ The grants of the Netherlands Government to New Guinea average \$7.8 million yearly.³⁰ Three-quarters of the cost of the Somaliland Economic Development Plan, which envisaged a total investment of \$17.4 million between 1954 and 1960, was borne by Italy.³¹

Other resources for public development have been supplied by the International Bank for Reconstruction and Development. Between 1952 and 1957 two loans of \$40 million were given the Belgian Congo, one of \$4.8 million to Ruanda-Urundi, and one of \$30 million to Belgium to finance exports to the Congo. The second \$40 million loan to the Congo involved participation by 14, to a large extent American, investment institutions to the extent of some \$6 million.

During the same period, Algeria benefited from a \$10 million loan for the development of electrical facilities and French West Africa obtained \$7.5 million for the modernization of railroads.³² In 1959, a \$35 million loan was extended to Comilog, a company established in Gabon (French Equatorial Africa) for the development of extensive high-grade manganese deposits.³³ Finally, \$5 million were made available by the High Authority of the European Coal and Steel Community to assist the Bureau Minier de la France d'Outre-Mer in its five-year program of prospecting for iron and manganese ores in certain African territories.³⁴

The Republic of the Congo is inhabited by roughly 13 million people of which less than one percent were, prior to its independence, Europeans, giving it the low density of 5.5 persons per square kilometer.³⁵ The activities of Europeans centered mainly around mining and the raising of cash crops. The Congo has rich deposits of min-

²⁹ Beaulieu, *supra* note 1, at 394.

³⁰ U.N., *supra* note 27, at 14.

³¹ O.E.E.C., ECONOMIC DEVELOPMENT OF OVERSEAS COUNTRIES AND TERRITORIES ASSOCIATED WITH OEEC MEMBER COUNTRIES 139 (1958).

³² See the 9th, 11-13th Annual Reports of the International Bank for Reconstruction and Development. Cf. also Krebs, *Algerischer Entwicklungsplan oder "Plan von Constantine,"* 3 EUROPÄISCHE WIRTSCHAFT 158 (1960). Cf., Brady, *All Algeria Won to Economic Plan*, N.Y. Times, Oct. 9, 1960, Sec. 1, 18:1.

³³ International Monetary Fund, XII INTERNATIONAL FINANCIAL NEWS SURVEY 9 (No. 2, July 10, 1959).

³⁴ European Coal and Steel Community, HIGH AUTHORITY, SEVENTH GENERAL REPORT ON THE ACTIVITIES OF THE COMMUNITY 209-210 (1959).

³⁵ Adjacent Ruanda-Urundi has a density of more than 80 persons per square kilometer which is only paralleled in Nigeria in the agricultural areas. O.E.E.C., *op. cit. supra* note 31, at 13.

erals amounting to 65 percent of the export receipts with copper being the most important. A large part of the world's reserve of uranium is in the Congo, and it is the world's largest producer of industrial diamonds. However, the greater part of the African population still depends on subsistence agriculture for livelihood, and the development of the area remains uneven. In spite of technical assistance, much of African agricultural activity is still primitive.³⁶

The economies of the territories of France³⁷ are all essentially agricultural and progress in agricultural production is slow. In Algeria four-fifths of the population still depend entirely on agriculture, with wine, cereals, and vegetables leading other commodities.

More striking progress is being made in mining. Until recently Algeria's mineral reserves were considered small, but new drillings in the Sahara, particularly in the Hassi-Messaoud region, have uncovered large crude oil reserves. Indeed, this fact has been reported to pose serious competitive problems for Venezuelan and Middle Eastern oil since Algerian oil may eventually permit France to become self-sufficient and to supply some of her E.E.C. partners, notably Germany.³⁸ Exploitation of Algerian oil is now in the hands of the French companies C.F.P.A. and REPAL.³⁹ Algeria has a fairly substantial processing industry, recent advances having been made particularly in the foodstuffs, building materials, and chemical industries.

French Africa south of the Sahara includes the most primitive and underdeveloped of the territories considered here. Agricultural produce amounted to over 90 percent of the total value of exports in 1955 whereas mining products represented less than 4 percent. Coffee, peanuts, and cocoa are the most important agricultural exports. Madagascar and the Comoro Archipelago in addition produce and export vanilla, sugar, tobacco, and cloves. Significant deposits of bauxite are found in Guinea (formerly French West Africa) and of manganese ore in Franceville, which is reputed to consist of up to 150 million tons of marketable ore with 50 percent manganese content.

³⁶ O.E.E.C., *supra* note 31, Part I, 13 ff. Doucy and Pouleur-Bouvier, *supra* note 28, at 200.

³⁷ *Ibid.*, Part II, 49 ff. Doucy and Pouleur-Bouvier, *supra* note 28, at 198.

³⁸ Carmical, *Problems Posed by Algerian Oil*, N.Y. Times, Sept. 13, 1959, Sec. 3, 1:1, 7:3. Cf. Rauchfuss, *Erdöl in den assoziierten Gebieten*, 3 EUROPÄISCHE WIRTSCHAFT 406 (1960). It was reported on October 9, 1960, that six million metric tons of Saharan petrol have been delivered to the Algerian port of Bougie by the new pipeline since pumping began in December of 1959. Brady, *supra* note 32, at col. 5.

³⁹ 1958 EUROPÄISCHE WIRTSCHAFTSGEMEINSCHAFT 342.

As a result of the dependence on agricultural products these areas are often severely affected by oscillating world prices. To remedy this situation a number of price stabilization funds have been established. The latest, the National Equalization Fund for Overseas Products established in 1955, alone received an initial allocation of approximately \$13.7 million under the 1956 budget.

III. ASSOCIATION WITH THE EUROPEAN ECONOMIC COMMUNITY^{39a}

A. IN GENERAL

I. THE POLICY OF THE TREATY

Integration of the Overseas Territories into the Community and the resultant application of all provisions of the Treaty would have been disastrous for the less developed economies of the Territories.⁴⁰ Instead, the Treaty therefore extends to them most of the trade advantages of the Common Market and provides for public investment capital to further development, at the same time protecting them from the full brunt of European competition by permitting the retention of certain trade barriers. In many areas other than trade the Treaty does not go beyond affirmation of a general policy of association, leaving details to further negotiation. This contrasts with other parts of the Treaty where the drafters took an intermediate step, creating a legal framework (a *loi-cadre*) to be filled in by the Community organs.⁴¹ The conservatism of the drafters in this regard is probably explained by the fear of some of the E.E.C. partners, notably Germany, that close association with the Overseas Territories would involve them in problems they did not wish to face. It was this fear which prompted inclusion of a reference⁴² in the substantive provisions of the Treaty to the Preamble, which in turn refers to the principles of the United Nations Charter, the right to self-determination as a principle of the association being thereby incorporated by reference.⁴³ This fear should now be alleviated by the provision in the new French Constitution

^{39a} See generally, COUSTRÉ, *L'ASSOCIATION DES PAYS D'OUTRE-MER À LA COMMUNAUTÉ ÉCONOMIQUE EUROPÉENNE* (1959).

⁴⁰ Bourcier de Carbon, *L'Association des Pays et Territoires d'Outre-Mer à la Communauté Économique*, 9 *REVUE ÉCONOMIQUE* 278, at 282 (1958).

⁴¹ Reuter, *Aspects de la Communauté Économique Européenne*, 1958 *REVUE DU MARCHÉ COMMUN* 161 at 164. Examples are arts. 135 and 136(2) of the Treaty.

⁴² In art. 131(3).

⁴³ Art. 73, U.N. CHARTER. Germany, Deutscher Bundestag, *Schriftlicher Bericht des 3. Sonderausschusses-Gemeinsamer Markt/Euratom-Drucksache 3660*, 56 (1957). The

allowing the Overseas Territories to become independent, either leaving or remaining within the French Community.⁴⁴

The association of these areas which are producers of primary products with industrialized nations under a treaty establishing a system of trade preferences has been likened to the British Commonwealth⁴⁵ with its system of imperial preferences. To what extent such a system may bring about a contraction of world trade will be discussed after consideration of the association provisions of the Treaty.

2. THE TREATY PROVISIONS IN DETAIL

Because the legal status of the territories differs, the Treaty differentiates among them.

1) Article 227 describes the territorial scope of the Treaty and includes in it Algeria and the French overseas departments, since constitutionally they are part of metropolitan France. It lists the modifications which were thought necessary.

2) A special, and separate, part of the Treaty (Articles 131–136) deals with the association of the Overseas Territories and is supplemented by an Implementing Convention annexed to the Treaty. These provisions are then further modified by special protocols. Annex IV of the Treaty lists the Overseas Territories concerned.

3) Finally, "Declarations of Intention" open the door to negotiations for association with the autonomous parts of the Netherlands (Surinam and the Antilles), with the independent countries of the franc area (Morocco, Tunisia), and with Libya with which Italy has special relations.

The association provisions will hereafter be considered without differentiating among the types of territories, except where differences exist in the treatment of the departments and the Overseas Territories.

Socialist Representative Metzger thought, however, that the use of the word "entsprechend" in art. 131 did not make this a self-evident incorporation by reference, but that it was a question of extensive *versus* restrictive treaty interpretation. Deutscher Bundestag, *Sitzungsbericht* 224. Sitzung, July 5, 1957, 13344. The extensive interpretation, however, was undoubtedly the intent of the parties. Cf. *Erläuterungen der Bundesregierung* in Bundestags-Drucksache 3440 (2. Legislaturperiode) in HANDBUCH IA 30, introductory comment to arts. 131–136. Cf. also Bundesrat, *Niederschrift über die Sitzung des Sonderausschusses "Gemeinsamer Markt und Euratom" vom 24. April 1957*, 41.

⁴⁴ Constitution of 1958 art. 86, para. 2.

⁴⁵ Germany, Deutscher Bundesrat, *supra* note 43, Anlage zu Punkt 5, Report by Senator Helmken 5.

B. THE SUBSTANCE OF THE ASSOCIATION

1. REMOVAL OF TRADE BARRIERS

a. *Tariffs*

One of the introductory Treaty articles states that the "objects"⁴⁶ of the association include extension to the Overseas Territories of the trade benefits which the Member States accord each other (gradual abolition of tariffs and quotas) and extension of most-favored-nation treatment by the Overseas Territories to the E.E.C. Member States. It will be noted that the "objects" of this Article concern only the Overseas Territories. Algeria and the overseas departments of France are governed by the same provisions relating to the free movement of goods as are the E.E.C. Member States.⁴⁷ The following Treaty provisions are designed to implement these "objects."

The Overseas Territories benefit from the same reductions in tariffs as apply to trade among Member States.⁴⁸ The Overseas Territories are also bound to abolish their customs duties with regard to imports originating in Member States or other associated Overseas Territories in conformity with the Treaty provisions relating to the free movement of goods.⁴⁹ This obligation is modified, however, insofar as the Overseas Territories may continue to impose duties, if this is necessitated by their level of development or fiscal needs. This authorization extends both to protective and revenue tariffs.⁵⁰

These protectionist safeguards are limited, however. On the one hand, the tariffs which are maintained under this authorization must be progressively reduced to the level of duties levied on imports originating in the Overseas Territory's mother country.⁵¹ New preferences may not be granted the metropolitan country. The pace of these reductions is to be that of tariff reductions among the

⁴⁶ "Objects" is actually an incorrect heading for art. 132, since in reality it sets out the "contents" of the association. HANDBUCH IA 59, 11.

⁴⁷ Art. 227(2).

⁴⁸ Art. 133(1).

⁴⁹ Art. 133(2). Express reference is made to the provisions of arts. 12, 13, 14, 15 and 17.

⁵⁰ Because they are subject to the ordinary provisions relating to the free movement of goods, the overseas *departments* may not use these safeguard measures. They may only avail themselves of those safeguard measures which are also open to the Member States, particularly those of arts. 108-109, 226. Cf. Leduc, *supra* note 4 at 209, n. 1.

⁵¹ Art. 133(3).

Member States. Consequently, if the stages of the transitional period applying to tariff reductions among the Member States are extended,⁵² the progression of reduction in the Overseas Territories will also be affected. The practical result of these provisions is, then, that imports originating in the Member States will be accorded what is essentially most-favored-nation treatment. On the other hand, the continued imposition of duties by the Overseas Territories is limited in time. They may only be imposed as long as they are economically necessary. Theoretically, therefore, the Treaty envisages total abolition of duties for trade in both directions at a time when the Overseas Territories are able to meet the increased competition. The compatibility of the association provisions with G.A.T.T. will primarily depend on whether the association is an arrangement designed to bring about a free-trade area "within a reasonable length of time" within the meaning of Article 24(5)(c) of G.A.T.T.⁵³ The creation of a free-trade area is theoretically possible, although the Overseas Territories will be able to impose safeguards during the foreseeable future. Despite this it is arguable that the test of "a reasonable length of time" should be interpreted more leniently in the case of presently underdeveloped countries than would be justifiable in the case of developed countries.

In order that the principle of non-discrimination, which forms the basis of the tariff provisions, will not be illusory, a special paragraph⁵⁴ prohibits all other discrimination whereby preferences could be granted a given metropolitan country by any Overseas Territory. Included in this prohibition are measures whereby duties are established on the basis of artificial distinctions between products to the end that a preferential tariff is established for goods from the metropolitan country.⁵⁵

Not affected by the obligation to extend at least most-favored-nation treatment to E.E.C. countries were those Overseas Territories which already had internationally established customs regimes requiring non-discriminatory treatment and which therefore could not extend preferences to the metropolitan country. This was

⁵² Cf. arts. 8 and 13. HANDBUCH IA 59, 15.

⁵³ HANDBUCH IA 59, 16. Brazil, Ceylon, Chile, Dominican Republic, Ghana, India, Indonesia, Pakistan, Rhodesia and Nyasaland, and the United Kingdom, however, consider the association a new preferential area which is contrary to Art. I of G.A.T.T. See G.A.T.T., Report of the Working Party on the Association of the Overseas Territories with the European Economic Community, Doc. L/805/Rev. 1, par. 12, 5 (1958).

⁵⁴ Art. 133(5).

⁵⁵ HANDBUCH IA 59, 18.

true of the United Nations trust-territories of Togo, Cameroons, Ruanda-Urundi, and Italian Somaliland.⁵⁶ It was also true of all Overseas Territories situated in the Congo basin (the Belgian Congo and parts of French Equatorial Africa) which were covered by the Act of Berlin and subsequent international agreements.⁵⁷ In accordance with their international obligations, these Overseas Territories applied non-discriminatory duties;⁵⁸ they were therefore not bound to make reductions since no preferences were extended to metropolitan countries. Consequently, only those Overseas Territories which actually accorded preferences to their metropolitan countries lowered their tariffs on January 1, 1959, with respect to other E.E.C. countries by 10 percent of the difference between the existing tariff and the preferential tariff.⁵⁹

Provision is also made for the possibility that association of the Overseas Territories may cause trade diversions ("diversions of commercial traffic"). In this case, a Member State adversely affected may request the Commission to propose appropriate measures to the other Member States. As one commentator pointed out, this procedure may prove inadequate and consideration should therefore be given to application by analogy of the provisions relating to similar situations in the E.E.C.⁶⁰ Under those provisions the Commission could authorize the Member State affected to take protective measures.

No mention is made of the external duties of the Overseas Territories, that is, those on goods from third countries. There is no problem if the Overseas Territory is a member of a customs union to which the metropolitan country belongs. In this case the E.E.C. external tariff will apply.⁶¹ Absent such a customs union, territories,

⁵⁶ Cf. art. 76(d), U.N. CHARTER.

⁵⁷ BRITISH AND FOREIGN STATE PAPERS, Vol. 76, 4 (1884-1885), and Vol. 82, 55 (1889-1890), and LEAGUE OF NATIONS TREATY SERIES, Vol. 8-9, 27 (1922). See also, *Belgique, Congo et Marché Commun*, 1958 BELGIQUE COLONIAL ET COMMERCE INTERNATIONAL 13 at 25 ff.

⁵⁸ E.g., in Cameroon, duties on most imports were 12% *ad valorem* in 1957 plus a small turnover tax. Some capital goods were admitted free of duty. Bureau of Foreign Commerce, WTIS, Part 1, No. 57-63, 15. In the Congo and Ruanda-Urundi duties were also levied on an *ad valorem* basis ranging from complete exemption to 50%, the average rate being 22%. Special provisions, often exemptions, applied to foodstuffs, farm machinery and equipment, and raw materials for local industry. No customs surtaxes were levied with the exception of a statistical tax of 0.05% *ad valorem* which was imposed on all imports and exports. *Ibid.*, Part 2, No. 57-89, 1.

⁵⁹ See Stohler, *op. cit. supra* note 26.

⁶⁰ Those would be the provisions of art. 115, paras. 1 and 3. HANDBUCH IA 59, 19.

⁶¹ HANDBUCH IA 59, 15. This would fall under art. 18 ff.

other than the French departments,⁶² remain free with respect to their external tariffs. Insofar as measures adopted by them cause diversion of trade the provision discussed in the preceding paragraph becomes applicable.

b. *Effect of the Tariff Provisions*

If these tariff provisions are viewed in context, it becomes apparent that the Overseas Territories enjoy a twofold benefit. The participation in the intra-European tariff reductions and eventual abolition of tariffs will open a larger market for raw materials supplied by the territories. Secondly, this position is strengthened by the protection the territories will enjoy by virtue of the E.E.C. external tariff on goods from third countries, some of them also suppliers of primary products.⁶³ This effect is quite important, as some examples will show. The Six imported 41.6 percent of their cocoa requirements in 1954 from the Overseas Territories. While the previous tariffs will be reduced and eventually abolished with regard to the Overseas Territories, List F of the Treaty envisages a tariff of 9 percent on cocoa imported from third countries. A more striking example, and one with more far-reaching effects, is that of coffee. The Six imported only 27 percent of their coffee needs in 1956 from the Overseas Territories,⁶⁴ but envisage an external tariff of 16 percent on coffee. So far, the Six have mainly imported the arabica variety of coffee from Brazil and Columbia. Since arabica can be mixed with the robusta variety for the production of instant coffee, imports of robusta from the Overseas Territories will undoubtedly increase, especially in view of the fact that robusta will enjoy tariff reductions in the Six (while arabica is faced with a duty of 16 percent). Robusta will therefore not only be cheaper but, at the same time, protected.

A similar trade-diverting effect may occur with respect to bananas; ⁶⁵ in 1956 the Six imported only 21 percent (approximately)

⁶² Art. 227; cf. Carstens, *Die Errichtung des gemeinsamen Marktes in der Europäischen Wirtschaftsgemeinschaft, Atomgemeinschaft, und Gemeinschaft für Kohle und Stahl*, 18 ZEITSCHRIFT FÜR AUSLÄNDISCHES ÖFFENTLICHES RECHT UND VÖLKERRECHT 459 at 464 and n. 15, 16 (1958).

⁶³ See Bourcier de Carbon, *supra* note 40 at 285.

⁶⁴ The import figures for both coffee and cocoa were taken from Bourcier de Carbon, *id.*, 294, n. 11. In 1956, the coffee imports from the Overseas Territories amounted only to 21.1% of total coffee imports. U.N., *supra* note 27 at 7. Cf. also G.A.T.T. *supra* note 53, *Report on Coffee*, Doc. L/805/Add. 2.

⁶⁵ With regard to the trade-diverting effect of the Treaty on coffee and bananas, see Report of the G.A.T.T. Working Party on Tropical Products, Press Bulletin

of their banana requirements from the Overseas Territories, but propose an external tariff of 20 percent on bananas from third countries.

These potentially dislocating effects on world trade of certain tropical products must, however, be viewed in the light of special provisions contained in two Protocols annexed to the Treaty. These Protocols reduce somewhat the dislocating effect of the Treaty provisions concerning coffee and bananas, although their inclusion was not primarily due to a desire to shield third countries from the effect of the Treaty; it was necessitated by the economic position of several of the E.E.C. Member States.⁶⁶ Germany had been importing large quantities of bananas duty-free from Ecuador, Colombia, Guatemala, and Honduras. The Protocol⁶⁷ therefore provides that Germany will be entitled to continue to import duty-free, until the end of the second stage of the transitional period, an amount equal to 90 percent of its 1956 imports of bananas less the amount imported from the Overseas Territories. At the end of the third stage, the duty-free quota will be decreased to 80 percent, and at the end of the transitional period to 75 percent. It can be augmented by 50 percent of the difference between the 1956 imports and the increase in successive years, but will be 80 or 90 percent of the imports of the years after 1956, if the 1956 level of imports is not attained. Similar provisions apply to imports of unroasted coffee into Italy and the Benelux countries.⁶⁸ The effect of protection by the external tariff is also lessened by the right of the Member States to substitute non-discriminatory internal fiscal taxes for the reduced tariffs; such action by Germany with respect to coffee has already caused some concern in the Overseas Territories.⁶⁹

One result of these provisions is that serious changes in the exist-

EUROPE, No. 357 item 1956 and No. 359 item 1983, March 9 and 11, 1959. G.A.T.T., *supra* note 64, and *Report on Bananas*, Doc. L/805/Add. 4.

⁶⁶ Cf. Rey, *L'Association des Territoires d'Outre-Mer au Marché Commun*, 1958 REVUE DU MARCHÉ COMMUN 50 at 51.

⁶⁷ Protocol Concerning the Tariff Quota for Imports of Bananas (Ex 08.01 of the Brussels Nomenclature).

⁶⁸ Protocol Concerning the Tariff Quota for Imports of Unroasted Coffee (Ex 09.01 of the Brussels Nomenclature).

⁶⁹ Arts. 17(3) and 95. Cf. Press Bulletin EUROPE, No. 331, item 1743, Feb. 5, 1959. Cf. Resolution of the European Assembly of Nov. 27, 1959, [1959] Journal Officiel des Communautés Européennes (hereinafter cited as J.O.) 1267/59 at para. 9(b), p. 1268/59, in which the Assembly urges Member Governments to execute the "spirit" of the Treaty and to refrain from substituting internal charges and "obstacles" for the tariff reductions.

ing patterns of supply of coffee and bananas may not occur in the near future during which the high quotas of the Protocols apply. However, as the larger European market raises the general standard of living and results in increased consumption, the special quotas under the Protocols will steadily decrease to fixed levels. To the extent that the high E.E.C. external tariff makes it unprofitable for third countries to export to the E.E.C., much of the increase in consumption could be satisfied by the Overseas Territories.

c. Quotas

The Treaty provisions relating to import quotas of the territories and to quotas applicable to their goods resemble the tariff provisions, although their effect is different because there is no quota equivalent of the common external tariff of the Six. The provisions⁷⁰ require Member States to apply the same quota increases to imports coming from the Overseas Territories as they apply to imports from other Member States. To the extent that present quotas of the Member States encompass imports both from an Overseas Territory and its metropolitan country, the percentage of the imports from the Overseas Territory has to be determined on the basis of import statistics. This will determine the quota of the Overseas Territory which will then be converted into a global quota and will follow the Treaty provisions as to annual increases.⁷¹ The obligation imposed on the Member States, however, does not preclude them from imposing such restrictions as are warranted by public morals, order, security, and health, or by the protection of national treasures or of commercial and industrial property.⁷²

These provisions ensure participation by the Overseas Territories in all intra-Community trade liberalization. The Overseas Territories, on the other hand, must "globalize" the quotas open to Member States other than the metropolitan country and extend them to all Member States. As a result, any preferences which the metropolitan country enjoys continue in existence; yet the "global quota" open to the other Member States will eventually reach the same degree of liberalization because the Overseas Territories must increase the global quotas annually by the same percentages which apply to the liberalization among the Six, that is, an annual increase by 20 percent of total value of the quotas, but no less than 10 percent for

⁷⁰ The provisions are found in arts. 9-14 of the Implementing Convention, annexed to the Treaty.

⁷¹ Art. 12, Implementing Convention.

⁷² Art. 13, Implementing Convention.

each product.⁷³ Where a global quota would represent less than 7 percent of a Territory's total imports of the product, a 7 percent quota must be established and increased according to the same scheme.⁷⁴ In the cases where the Overseas Territories had heretofore offered no quota, the Commission is to determine the size of the quotas as well as the scale of increases.

With respect to these quota measures several points must be noted. In the first place, the obligation of the Overseas Territories to extend globalized quotas to the Member States is, like their obligation in the tariff field, a relatively small burden. Quotas, like tariffs, are covered by the open-door policy of the Act of Berlin and of the trusteeship provisions of the United Nations Charter; the Overseas Territories of the Congo Basin and the trust territories were therefore already required to accord non-discriminatory treatment to the Six. Theoretically, the quota provisions go further than the tariff provisions in that they not only require reduction of discriminatory treatment to the level of the advantages accorded the metropolitan country but envisage total abolition eventually. However, considering that tariffs may only be maintained as long as economically necessary, the end effect supposedly will be total abolition of barriers in both cases.

Secondly, just as the tariff provisions leave the Overseas Territories free to determine their own external tariffs, so the Overseas Territories are unaffected by the commercial policy of the E.E.C.⁷⁵; they are free to determine their own quotas with regard to third countries subject to the above-mentioned international obligations. There is an interesting—and unexplainable—difference between the provisions applicable to the departments on the one hand, and to the Overseas Territories on the other. The Overseas Territories continue to be free, from the point of view of the E.E.C. Treaty, to set their own external quotas and tariffs. Yet, while external

⁷³ Art. 11, Implementing Convention, which refers expressly to the percentages of art. 33. Reference is also made to art. 32; its provisions—that no new more restrictive quotas may be imposed and that the objective is the total abolition of quotas by the end of the transitional period—are therefore also applicable to the Overseas Territories.

⁷⁴ A difficult question of interpretation has arisen. Since art. 11 of the Implementing Convention refers to art. 33 of the Treaty, the question arises whether the 7% of "total imports" (art. 11(2)) shall replace or be added to a quota of 3% of national output. The Commission has taken the position that it is in addition to the 3% because of the express reference in art. 11. If the Overseas Territories are prejudiced thereby, they can levy protective tariffs under art. 133(3). Press Bulletin EUROPE, No. 339, item 1810, Feb. 16, 1959.

⁷⁵ Arts. 110 ff.

E.E.C. tariffs apply immediately to Algeria and the departments,⁷⁶ the provisions concerning the E.E.C. common commercial policy apply only after the Council renders a decision by unanimous vote within two years after the entry into force of the Treaty.⁷⁷ A third problem results from the fact that the level of economic development of the French Overseas Territories necessitates stabilization and subsidy measures by France. A special protocol⁷⁸ therefore authorizes continued export subsidies and import charges up to the level existing on January 1, 1957. The Council and Commission may examine these systems periodically, and, if their lack of uniformity prejudices industry, may request France to take appropriate measures in the areas of raw materials, semi-finished products, and finished products. Member States may take safeguard measures, if France does not comply. Since the purpose of this Protocol is the maintenance of an equilibrium in the balance-of-payments of the franc zone, the Council may decide by a qualified majority vote that the system must be discontinued, if equilibrium is reached and monetary reserves are satisfactory. If no agreement can be reached, the Protocol—deviating from the usual procedure of the Treaty⁷⁹—envisages arbitration by a mutually appointed arbitrator, or, in case of disagreement, by an arbitrator appointed by the President of the Court of Justice.

*d. Problems of Third Country Preferences and
Origin of Goods*

Two further problems are closely connected with each other. They arise because some of the Member States have special relations with countries which are independent and therefore could not be affected by the Treaty. Although the customs union between France and Tunisia has terminated,⁸⁰ France accords trade preferences to, and enjoys preferences of, Tunisia as well as Morocco, Cambodia, Laos, and the Condominion of the New Hebrides. Similarly,

⁷⁶ Cf. Carstens, *supra* note 62.

⁷⁷ Art. 227(2).

⁷⁸ Part I, Protocol Relating to Certain Provisions of Concern to France. Cf. also HANDBUCH DER MONTANUNION, A 2012, 24-26.

⁷⁹ The only other use of arbitration is found in art. 8(4) of the Treaty with respect to the extensions of the stages of the transitional period. Otherwise arbitration of differences among Member States concerning the interpretation or application of the Treaty is expressly precluded by art. 219, and the procedures of arts. 169 or 170 become applicable.

⁸⁰ N.Y. Times, Aug. 21, 1959, 1:1.

Italy grants preferences to Libya, and the Netherlands to the autonomous parts of its Kingdom, Surinam, and the Antilles. These countries could not be included in the association, but Declarations of Intention invite those countries to negotiate for association. Negotiations have already started with Tunisia.⁸¹ An interim solution was therefore necessary with respect to products entering the metropolitan countries on a preferential basis. A special protocol⁸² therefore expressly declares the provision concerning *libre pratique* inapplicable to these imports. That provision⁸³ accords duty-free entry into a Member State to goods which have entered another Member State and have been subject there to imposition of duty and have not enjoyed any drawbacks of such duties or charges on leaving this second state. Thus, the effect of the Protocol is that, because of preferences enjoyed by these products upon entry into the metropolitan country, they cannot benefit from the removal of intra-Community duties.

Closely connected with this is the general problem of how to determine whether a particular shipment of goods benefits from the Treaty reductions. In the Community, including Algeria and the overseas departments, a Certificate of Commercial Traffic (*Warenverkehrsbescheinigung*) must accompany all shipments.⁸⁴ For trade with the Overseas Territories, Certificates of Origin must also accompany shipments; these will serve to certify both the fact that the shipment is entitled to benefit from the percentage reduction currently in effect and that the goods originated in the Community or the Overseas Territories. Since all Overseas Territories benefit from the intra-Community reductions, this certificate must accompany all shipments to the Community. On the other hand, it need only accompany Community shipments to the Overseas Territories where the Member States will benefit from the preferences extended by an Overseas Territory to its metropolitan country. Such a certificate must therefore accompany products exported to French West Africa, New Caledonia, St. Pierre and Miquelon, and the French Settlements in Oceania. Since the other Overseas Territories do not extend preferences to their metropolitan countries, other Member

⁸¹ Press Bulletin EUROPE, No. 416 item 2460, 23 May 1959. Indications are that Tunisia is not seeking association on the basis of the Declaration of Intention but rather under art. 238 of the Treaty.

⁸² Protocol Relating to Goods Originating in and Coming from Certain Countries and Enjoying Special Treatment on Importation into One of the Member States.

⁸³ Art. 10 of the Treaty.

⁸⁴ 2 EUROPÄISCHE WIRTSCHAFT 48 (1959).

States will not benefit from reductions,⁸⁵ and no certificates need accompany shipments to those Territories.

*e. Special Problems: Duration of the Association;
Relation to the Coal-Steel and Euratom Treaties*

Two problems remain. One concerns the duration of the association, the other the relation of the E.E.C. Treaty to that of the Coal-Steel Community and to that of the European Atomic Energy Community.

While Article 227 extends the application of the Treaty, with modifications, to Algeria and the overseas departments—and thus for an unlimited time⁸⁶—, the association of the Overseas Territories is accomplished partly by means of provisions in the body of the Treaty and partly by means of the Implementing Convention. The latter expires five years after the entry into force of the Treaty (December 31, 1962).⁸⁷ At that time, the Council must determine by unanimous vote the form of continued association. The Council may pass only on the *form* of association, however, and not on *whether* to continue it.⁸⁸ The result of the two separate Treaty sources for association is that the provisions for reduction, and eventual abolition, of tariffs continue to be in force after five years since they are contained in the main body of the Treaty, while the quota increases will freeze at the point of liberalization reached by the fifth year, pending extension by the Council.⁸⁹ The reason for the difference in treatment was probably the desire to evaluate the political impact of the association before entering into a long-range commitment. Nevertheless, it would seem that, except for slight or non-existent quotas whose liberalization starts at a low level, the annual liberalization of *quotas* according to the “20 percent-of-total-imports—10 percent-minimum-per-product” scheme will have reached substantial enough proportions at the end of the fifth year to make continued liberalization of *tariffs* meaningful.

The second problem concerns the effect of the association on coal and steel products and products covered by the Euratom Treaty.

⁸⁵ *Ibid.*

⁸⁶ Art. 240.

⁸⁷ Art. 17, Implementing Convention, art. 136 Treaty.

⁸⁸ HANDBUCH IA 59, 22. The Council must take into account the principles of arts. 131 and 132.

⁸⁹ Cf. art. 14, Implementing Convention; HANDBUCH IA 59, 21.

Coal and steel products⁹⁰ are subject to the Coal-Steel Treaty⁹¹ which only applies to the European territories of the Member States.⁹² The E.E.C. Treaty, moreover, expressly provides that its provisions shall not "modify" those of the Coal-Steel Treaty.⁹³ A protocol promises future negotiation on the extension of the Coal-Steel Treaty to the overseas departments.⁹⁴ The problem therefore arises: to what extent do the movement-of-goods provisions of the association also apply to coal and steel products? In the first place it is necessary to emphasize again that the problem exists only with respect to coal and steel products as defined by *that* Treaty; thus tin, of which the Belgian Congo supplied 9 percent of world exports at last report, is not covered by the Coal-Steel Treaty and can, therefore, be considered to be covered by the movement-of-goods provisions of the E.E.C. Treaty. On the other hand, tin-plate is covered by the Coal-Steel Treaty. It is with respect to such products that the problem exists.

The relation of the Coal-Steel Treaty to the E.E.C. Treaty is that of a special law to a general law.⁹⁵ To the extent that the Member States retained powers in regard to products covered by the Coal-Steel Treaty after the establishment of the Coal-Steel Community, they were free to delegate them in a new treaty. The general assumption must be, then, that because of the comprehensive scope of the E.E.C. Treaty the residual powers remaining with the Member States under the Coal-Steel Treaty were delegated by them under the new treaty. A case-by-case analysis must determine whether: (1) such residual powers exist under the Coal-Steel Treaty, and (2) whether their coverage by the E.E.C. Treaty is precluded by an express reservation in that Treaty, or (3) whether their coverage by the E.E.C. Treaty would prejudice the Coal-Steel Treaty.⁹⁶ For instance, the question arises whether the E.E.C. ex-

⁹⁰ Listed in Annex 1, as qualified by Annexes II-III of the E.C.S.C. Treaty.

⁹¹ Art. 81, E.C.S.C. Treaty.

⁹² Art. 79, E.C.S.C. Treaty. Paragraph 2 of that Article obligates Member States to extend to each other any preferential treatment which they enjoy in their Overseas Territories. This provision is immaterial for our purposes since we are here concerned with movement of such products *from* the Overseas Territories to the Six.

⁹³ Art. 232. Author's translation from the German, since the English term used in the extant translation seems inadequate.

⁹⁴ Protocol Relating to the Treatment to be Applied to Products within the Competence of the European Coal and Steel Community in Respect of Algeria and the Overseas Departments of the French Republic.

⁹⁵ Carstens, *supra* note 62 at 462.

⁹⁶ As Carstens, *ibid.*, 465-466, observes, the Protocol, *supra* note 94, does not change this. It is merely an expression of the willingness to negotiate an agreement which

ternal tariff applies to coal and steel products, given the fact that the Coal-Steel Treaty does not make provision for an external tariff. Since coal and steel products have been expressly excluded by the E.E.C. Treaty,⁹⁷ the conclusion must be, however, that the external tariff does not apply to coal and steel products in Algeria and the departments—the only territories where the E.E.C. external tariff applies at all. Similarly, the reduction and abolition of internal trade barriers between the Community and the territories, including the departments, does not apply to coal and steel products. Although this conclusion is not based on a Treaty provision expressly dealing with the problem, it is plainly justified since an extension of the reach of the E.E.C. Treaty to include coal and steel products would constitute a substantial change in the Coal-Steel Treaty, and would thereby violate Article 232 of the E.E.C. Treaty.

For *practical* purposes, then, the E.E.C. provisions on movement of goods in the territories do not apply to coal and steel products. The *theoretical* conclusion that it is at least conceivable that the two treaties complement each other, is significant, however, in regard to two contingencies.

The tariff provisions, and the quota provisions upon extension by the Council, share the E.E.C. Treaty's unlimited duration. In contrast the Coal-Steel Treaty is limited to 50 years (that is, it expires in the year 2002).⁹⁸ If the Coal-Steel Treaty should expire at that time, the prohibition of Article 232 of the E.E.C. Treaty would become superfluous; absent a *lex specialis*, the E.E.C. provisions would apply.⁹⁹ Secondly, it has been suggested that Coal-Steel Community commercial policy will to a large extent become part of E.E.C. commercial policy.¹⁰⁰ This results from the Coal-Steel Treaty provision that the Member States remain responsible for this policy except where the Treaty provides otherwise.¹⁰¹ While the Coal-Steel Treaty in fact regulates some details of commercial policy, no provision comparable to the E.E.C. Treaty chapter on commercial policy exists. When the E.E.C. institutions assume responsibility for the commercial policy of the Community—and that

would eliminate the "problems." Up to that time, the effects of the Treaties on each other must be determined in accordance with what they themselves provide.

⁹⁷ Annex I, E.E.C. Treaty: List B, position 26.01; List C, positions 7307, 7310-7313, and 7315.

⁹⁸ Art. 97, E.C.S.C. Treaty.

⁹⁹ Carstens, *supra* note 62 at 463.

¹⁰⁰ *Ibid.*, 520-522.

¹⁰¹ Art. 71, E.C.S.C. Treaty.

of Algeria and the overseas departments¹⁰² at the end of the transitional period,¹⁰³ this commercial policy will include, therefore, that residual competence of the Member States with respect to coal and steel products in the departments. The Council and Commission can then conclude agreements with third countries affecting coal and steel, after consultation with the High Authority.¹⁰⁴

The Euratom Treaty—also, in relation to the E.E.C. Treaty, *lex specialis*¹⁰⁵—applies fully to all “non-European territories under the jurisdiction of a Member State.”¹⁰⁶ It thus applies to some very important products of the Overseas Territories, such as uranium.¹⁰⁷ To the extent that they are to be used for nuclear purposes, other products, such as aluminum and manganese,¹⁰⁸ may also be subject to the Euratom Treaty. In the latter case it must be noted that the E.E.C. Treaty is applicable until a determination is made that the products are intended for nuclear purposes.

In contrast to the manner of association under the E.E.C. Treaty, the Euratom Treaty contains few special rules applicable only to the territories. This difference between the Euratom and E.E.C. Treaties is probably accounted for by the fact that fewer protective and transitional measures are necessary to integrate incipient atomic industries than to achieve a common market in all sectors of the economy. This is illustrated by the Euratom provision allowing the Overseas Territories to continue to levy revenue tariffs on imports from the Six.¹⁰⁹ A counterpart of the far-reaching E.E.C. provision¹¹⁰ allowing the territories also to impose protective tariffs is, however, lacking in the Euratom provision.

2. OTHER PROVISIONS: AGRICULTURE, RIGHT OF ESTABLISHMENT, LIBERALIZATION OF SERVICES, AND FREE MOVEMENT OF WORKERS

a. *Agriculture*

For purposes of trade *among the Member States*, the Treaty contains two groups of provisions concerning agriculture. First, agri-

¹⁰² Cf. art. 227 which provides that the Council must decide within two years the mode of application of, *inter alia*, the commercial policy provisions.

¹⁰³ Cf. arts. 110 and 113.

¹⁰⁴ Arts. 113 and 114, E.E.C. Treaty; art. 75, E.C.S.C. Treaty.

¹⁰⁵ Art. 232(2), E.E.C. Treaty.

¹⁰⁶ Art. 198, Euratom Treaty.

¹⁰⁷ Annex IV, List A' Euratom Treaty.

¹⁰⁸ Annex IV, List B Euratom Treaty.

¹⁰⁹ Art. 93, Euratom Treaty.

¹¹⁰ Art. 133(3), E.E.C. Treaty.

cultural products are included in the general movement-of-goods provisions; and second, a special part of the Treaty, applying to agricultural products specified in Annex II of the Treaty, provides for a common agricultural policy. This common policy is to be based on a common organization which will differ from product to product and might take the form of common rules of competition, or of compulsory coordination of the various existing national market organizations, or even of a single "European" market organization for the particular product. Any one of these forms may comprise price controls, production and marketing subsidies, stockpiling and other arrangements, as well as special loan and guarantee funds. Proposals for a common policy are under consideration by the institutions of the Community. While agricultural products are also included in the movement-of-goods provisions relating to the overseas departments and Overseas Territories the question is whether the special chapter on a common agricultural policy applies to them also. The Treaty gives an affirmative answer with regard to Algeria and the overseas departments, excluding only the provision concerning the agricultural funds and organizations mentioned above.¹¹¹ The provisions governing the association with the Overseas Territories do not mention the chapter; since the association extends only to matters expressly mentioned,¹¹² the application of that chapter is therefore precluded. Exclusion of the Overseas Territories from the common agricultural policy does not mean, however, that they cannot be affected by it. This is true because the provisions of the special chapter on common agricultural policy apply to the products specified in Annex II (including, for example, coffee, cocoa, cane sugar) rather than to a particular *geographic area*.¹¹³ Measures taken, for instance, by a European marketing organization¹¹⁴ or by the Member States (such as the invocation of the safeguard clause permitting, for the duration of the transitional period, the temporary suspension of imports or the fixing of minimum prices on imports)¹¹⁵ may therefore affect the Overseas Territories.

b. *The Right of Establishment* ¹¹⁶

The right of companies and nationals of the Member States to establish themselves in the Overseas Territories and overseas de-

¹¹¹ Art. 227.

¹¹² See language in art. 227(3).

¹¹³ Art. 38(3). Rey, *supra* note 66 at 52.

¹¹⁴ Art. 40(2)(c).

¹¹⁵ Art. 44(1).

¹¹⁶ See generally, Lussan, *Le Droit d'Établissement des Ressortissants et Sociétés*

partments and vice-versa is treated in three different provisions.

The right of establishment of nationals of the Member States in Algeria, the overseas departments, and Overseas Territories¹¹⁷ is regulated by a provision in the Implementing Convention.¹¹⁸ It provides that the Council, acting by qualified majority vote¹¹⁹ on a proposal of the Commission, must determine the particulars of an extension of the right within one year from the entry into force of the Convention (January 1, 1958). The material content of the right of establishment will be determined by the general chapter on the right of establishment in the Member States (Articles 52-58);¹²⁰ it is limited, however, to an abolition of discrimination between the right of establishment enjoyed by nationals of the metropolitan country of the department or Overseas Territory in that department or Overseas Territory and the right of establishment enjoyed by nationals of other Member States.¹²¹ The Council took the required action by issuing a Directive in November 1959.^{121a} One difficult question of interpretation is whether the right of establishment also includes the right of investment of capital necessary for establishment. A possible view is that, since the provision dealing with the right of establishment in the departments and Overseas Territories¹²² refers as to substance to the general right-of-establishment provision (Article 52) which in turn expressly excludes matters dealt with in the chapter concerning free movement of capital, the right to invest is not included in the right to establish. Moreover, the free-movement-of-capital provisions may be extended to Algeria and the departments by the Council under Article 227,¹²³ although no such provision exists with regard to the Overseas Territories. These facts suggest that no Treaty right to invest capital in the Overseas Territories exists and that the right of establishment could be virtually meaningless. It has therefore been suggested that the limitation of Article 52 should

d'Outre-Mer dans la Communauté Économique Européenne, 1959 REVUE DU MARCHÉ COMMUN 226; Brunner, *Das Niederlassungsrecht in den assoziierten überseeischen Ländern und Hoheitsgebieten*, 2 EUROPÄISCHE WIRTSCHAFT 254 (1959).

¹¹⁷ Cf. Art. 16, Implementing Convention.

¹¹⁸ Art. 8, Implementing Convention.

¹¹⁹ Cf. Art. 148, para. 2.

¹²⁰ Art. 132(5). KOMMENTAR ZUM EWG—VERTRAG, VON DER GROEBEN AND VON BOECKH, editors, 2 vols. (1958) (hereinafter cited as KOMMENTAR) vol. 1, 550.

¹²¹ KOMMENTAR Vol. 1, 551.

^{121a} [1960] J.O. 147. The Directive envisions extension of the right of establishment by stages according to the type of activity involved.

¹²² Art. 132(5).

¹²³ This was done by decision of the Council, [1960] J.O. 919-20.

not be applied to the right-of-establishment provision relating to the Overseas Territories and that the provision should be interpreted extensively to include the right to invest capital as a necessary concomitant to the right of establishment.¹²⁴

The right of establishment of nationals of the Overseas Territories in Member States is not as explicitly regulated as the right of nationals of the Member States to establish in the Overseas Territories, and is also different from that of nationals of the departments. Article 132(5) of the Treaty provides only that

In relations between Member States and . . . the Territories, the right of establishment . . . shall be regulated in accordance with the provisions . . . in the Chapter relating to the right of establishment [Articles 52–58]. . . .

The absence of a specific provision like that concerning the right of nationals of the Member States to establish themselves in the Overseas Territories has led some to conclude that no right of establishment in the Member States is given to nationals of the Overseas Territories.¹²⁵ Another possible interpretation is that as long as no special provision is made, the general provision of Article 132(5) applies, so that the intra-Community right of establishment as provided by Articles 52–58 extends to nationals of the Overseas Territories.¹²⁶ Furthermore, it has been argued, that a right of establishment in the Member States could accrue to nationals of the Overseas Territories under Article 52 of the Treaty because nationals of the French Territories have French citizenship and thus satisfy the nationality requirements of Articles 52 and 58.¹²⁷ The latter interpretation is preferable to one denying a right of establishment of nationals of the Overseas Territories, since the object of the association is the furthering of the interests of the Overseas Territories¹²⁸ and since the policy of Article 132(5) seems clearly to indicate that reciprocity was desired in matters relating to the right of establishment.

The right of establishment of nationals of Algeria and the departments in the Member States, finally, is left open by the Treaty. Like all other matters not expressly mentioned in Article 227(2),

¹²⁴ KOMMENTAR Vol. 1, 550.

¹²⁵ Cf. Lussan, *supra* note 116 at 227.

¹²⁶ *Ibid.* 228, 229; KOMMENTAR Vol. 1, 489.

¹²⁷ Lussan *supra* note 116 at 228–232. Cf., however, the impact of independence of many Territories on this argument.

¹²⁸ Arts. 131, paras. 2–3 and the Preamble.

its extension to the departments was to have been affected by the Council before January 1, 1960.

c. *Free Movement of Workers*

This area is again left to further implementing action by the Council in the cases of Algeria and the overseas departments. In the case of the Overseas Territories, the Member States have only affirmed a desire that free movement of workers be achieved.¹²⁹ In contrast to the procedure envisaged for the departments, implementation will not be effected by a Community institution but by means of international conventions. Since bilateral conventions could seriously affect non-participating Member States, every convention requires unanimous agreement of all Member States.¹³⁰

d. *Freedom to Perform Services and Other Provisions*

The Treaty's provisions concerning services, rules of competition, and institutions are immediately applicable to Algeria and the overseas departments; all other provisions become applicable in the departments upon decision of the Council.¹³¹ None of these provisions, with the exception of some financial provisions to be mentioned later, are applicable to the Overseas Territories nor is their extension envisaged for a later time. This difference in treatment is explainable by the fact that the overseas departments, belonging structurally to the metropolitan country, are to become part of the Community subject only to those modifications which their particular economic situations necessitate. In contrast, association alone is envisaged between the Community and the Overseas Territories. Since the main aim of this association is to raise the level of economic development in the Overseas Territories, the trade provisions are supplemented by special provisions, including those noted earlier and particularly those concerning financial assistance to be discussed presently. Since this system of association is limited to five years, a closer association is possible thereafter. However, even if a closer association should come about, the Treaty drafters were careful to indicate that it is the economic interest of the Territories which will primarily determine its form.¹³²

¹²⁹ Art. 135.

¹³⁰ HANDBUCH IA 59, 19-21.

¹³¹ Art. 227(2). Cf. also note 123 and preceding text.

¹³² See the implied reference in art. 136, para. 2 to the principles of arts. 131 and 132. Cf. HANDBUCH IA 59, 22.

3. FINANCIAL PROVISIONS

The two main reasons why France pressed for inclusion of the territories were her desire to avoid membership in two competing systems of trade preferences and her belief that she could not extend trade concessions to her European partners without receiving their assistance in financing economic development in the territories. The establishment of the Development Fund¹³³ was the response to France's position on the second point. Demands by France and Belgium that the expenses of the territories be shared by the Member States on a pro rata basis of national income were rejected early in the negotiations by the other four. Similarly, it was made clear that any assistance given should not serve to finance "sovereignty expenses" (police, administration, defense) of the powers directly involved. Thirdly—and as a further safeguard against too direct involvement—Germany demanded that any assistance given by a development fund to which she would contribute should only be given on a project-by-project basis, and that approval of local authorities in the territories would be required for every project.¹³⁴

Established along these lines, the Development Fund provides for a total contribution of \$581,250,000 by the Member States, of which Germany and France will contribute \$200 million each. Throughout its duration (geared to the five-year duration of the Implementing Convention) France will be the major beneficiary, receiving \$511,250,000 for her affiliated territories. The projects to be financed fall into two categories: "economic," including "productive and specific development projects," and "social," such as schools, hospitals and the prevention of soil erosion.¹³⁵ Each year the Council must determine by qualified majority vote, after consulting the Commission, what proportions of the amounts available for the year are to be allocated to the two categories.¹³⁶ In 1958 two-thirds of the available \$58 million were allocated to social, and one-third to economic, projects.¹³⁷ In 1959 the Council changed the

¹³³ Arts. 1-7, Implementing Convention.

¹³⁴ Germany, Bundesrat, *Niederschrift über die Sitzung des Sonderausschusses "Gemeinsamer Markt und Euratom" vom 24. April 1957*, 36, 42-43.

¹³⁵ Art. 3 Implementing Convention; See generally, Wirsing, *Politik und Arbeitsweise des Entwicklungsfonds*, 2 EUROPÄISCHE WIRTSCHAFT 229 (1959). The types of projects are defined in more detail in Commission Regulation No. 7, [1959] J.O. 241/59.

¹³⁶ Art. 4, Implementing Convention. Annex B to the Convention sets out the amounts available to each metropolitan country for its territories in each of the five years of the association.

¹³⁷ Wirsing, *supra* note 135 at 233.

percentage allocation to allow 25–30 percent of the available funds to be used for social investments while 70–75 percent were to be used for economic projects.¹³⁸ The qualified majority vote is based upon a special weighing of votes according to the size of contribution to the Fund. Thus, France and Germany, as the two largest contributors, command 33 votes each, Italy, Belgium, and the Netherlands 11 each, and Luxembourg 1. The qualified majority necessary for a decision constitutes 67 out of the 100 possible votes.¹³⁹ The country with the strongest political misgivings about the association, Germany, can easily prevent a vote with the support of only one like-minded state such as Luxembourg or the Netherlands, while only the votes of France, Germany, and Luxembourg are needed to adopt any measure.¹⁴⁰

After the Council has established the yearly quotas, the Commission may consider project proposals which have been drawn up by the competent authority in the Member State together with the local authorities in the territories.¹⁴¹ The Commission may then approve "social projects." "Economic projects" must be communicated to the Council which may pass on them within two months by qualified majority vote; if no Member State has requested the Council to consider the project proposal within one month, the projects are regarded as approved.¹⁴² In fact, several projects have already been approved. Among them are social and economic projects for the former Belgian Congo and for Ruanda-Urundi and economic projects for the disaster-stricken Malagasy Republic (formerly Madagascar).¹⁴³ Participation in the work on these projects is open to all nationals and companies of the Member States without discrimination.¹⁴⁴

The provisions of the Development Fund apply both to the Overseas Territories and to the departments.¹⁴⁵ However, the head of the French delegation declared that his government intended to make project applications only for the Overseas Territories and not

¹³⁸ Press Bulletin EUROPE, No. 471, item 2909, July 27, 1959.

¹³⁹ Art. 7, Implementing Convention.

¹⁴⁰ The qualified majority feature was also included on German insistence. Bundesrat, *supra* note 134 at 43.

¹⁴¹ Art. 2, Implementing Convention.

¹⁴² Art. 5, Implementing Convention.

¹⁴³ Press Bulletin EUROPE, No. 340, item 2142, April 7, 1959; No. 388, item 2197, April 16, 1959; and No. 408, item 2386, May 13, 1959. Cf. also, Wirsing, *supra* note 135 at 234. Cf. *Genehmigte Projekte des EWG—Entwicklungsfonds*, 3 EUROPÄISCHE WIRTSCHAFT 206 (1960).

¹⁴⁴ Art. 132(4).

¹⁴⁵ Art. 16, Implementing Convention.

for the departments.¹⁴⁶ It is also the understanding that the assistance of the Fund shall not replace, but shall be complementary to, the assistance rendered by the metropolitan countries.¹⁴⁷

As important as the Fund is for the economic development of the Overseas Territories, it leaves many questions unanswered. If one agrees with the basic political objective—that the Overseas Territories should be freed from economic dependence and should be assisted in achieving a level of economic development which would enable them both to maintain independence and to associate themselves with the Community as partners¹⁴⁸—the provisions of the Treaty concerning investment appear to be merely a preliminary step and, as such, insufficient. Early in 1959 the Commission had already received approximately 200 official project applications and was unofficially informed of several more.¹⁴⁹ Moreover, the Development Fund, by its nature, provides funds only for public investment. It is not designed either to facilitate private investment or to provide funds for it. The Treaty's provisions for the free movement of capital have been made applicable to the departments (Article 227), but are not applicable to the Overseas Territories unless an extensive interpretation of the right of establishment provisions incorporates them. The same is true of the provision¹⁵⁰ envisaging non-discriminatory treatment of nationals of other Member States in matters of financial participation in national companies. The provisions of the European Investment Bank, designed to help finance private investments, are applicable only to the European territories of the Member States and therefore exclude both the departments and the Overseas Territories. Exceptions are possible but require unanimous agreement of the Member States represented on the Bank's Board of Governors.¹⁵¹ Some use-

¹⁴⁶ Cf. France, Assemblée Nationale, *Rapport Fait au Nom de la Commission des Affaires Étrangères* . . . , No. 5266 (1957), 104.

¹⁴⁷ Cf. art. 1, Implementing Convention which, however, is not quite clear on this point. This is, however, the understanding in Germany and Luxembourg. Cf. Bundesrat, *supra* note 134 at 43, and *Erläuterungen der Bundesregierung*, *supra* note 43, comment to art. 1 of Implementing Convention; Luxembourg, Chambre des Députés, *Projets de loi portant approbation du Traité instituant la C.E.E.* . . . , *exposé des motifs*, (Nos. 636', 637', 638',—1956–1957), 28.

A further function of the Council included the establishment of rules for the transfer of contributions to, and the budgeting and administration of, funds of the Development Fund. Art. 6, Implementing Convention. Two regulations have already been issued. Regulation No. 5, [1958] J.O. 681/58 and Provisional Regulation No. 6, *id.*, 686/58.

¹⁴⁸ Cf. Luxembourg, Chambre des Députés, *Rapport de la Commission Spéciale sur les Aspects Économiques et Sociaux du Traité*, No. 6375C (1956–57), 15–16.

¹⁴⁹ Wirsing, *supra* note 135 at 233.

¹⁵⁰ Art. 221.

¹⁵¹ Art. 18(1) Protocol on the Statute of the European Investment Bank.

ful suggestions have already been made as to how this situation may be remedied.¹⁵² One category of suggestions concerns possible changes in territorial legislation and practice. Among them one, for instance, calls for abolition of discrimination against foreign majority interests by the substitution of a system of guarantees to be given by the companies to local authorities insuring to all a local supply of raw materials.¹⁵³ Along the same lines it has been suggested that International Charter Companies should be created, that is, companies constituted according to multilateral international conventions between the metropolitan country and third countries.¹⁵⁴ Another category of suggestions aims at changes in the Treaty and its policy of association. These suggestions are directed mainly at an expansion of the functions of the European Investment Bank (for instance, by eliminating the territorial limitation), and at the creation of a European Finance Company for investments in the Overseas Territories.¹⁵⁵ Yet another category of suggestions goes beyond the investment needs of the territories under examination here. For example, it has been suggested that the Community investigate the possibilities of establishing a financial assistance program for underdeveloped areas bordering on the associated territories in order to prevent assistance given the associated territories from resulting in undesirable political and psychological reactions in those areas.¹⁵⁶ All of these proposals emanate from the same important realization that only intelligent, generous and widely ranging assistance to the underdeveloped areas can create a true partnership.

While any of these proposals would be a step in the right direction, the problem is actually much larger. The availability of investment funds—by itself a problem¹⁵⁷—is of little value if unaccompanied by adequate provisions removing discrimination against foreign majority interests for example.

An additional problem is posed by the variations in risk insur-

¹⁵² Cf. also Resolution of the European Assembly of Nov. 27, 1959, para. 8, [1959] J.O. 1267/59 at 1268/59.

¹⁵³ DE LATTRE, *op. cit. supra* note 8, 70 and 91 ff.

¹⁵⁴ *Ibid.*

¹⁵⁵ These proposals were made by the Belgian Committee of the European League for Economic Cooperation. They were reported by Press Bulletin EUROPE, No. 409, item 2396, May 14, 1959.

¹⁵⁶ Wirsing, *supra* note 135 at 234.

¹⁵⁷ Frisch indicates in SOCIÉTÉ D'ÉTUDES ET DE DOCUMENTATIONS ÉCONOMIQUES, INDUSTRIELLES ET SOCIALES, No. 683 (1957) that German industrialists are interested in principle in investing in Africa, but lack the necessary capital. The high level of German investment is achieved primarily by self-financing, leaving little for outside (e.g. African) projects.

ance of export financing. Illustratively, a German exporter is required by government regulation to assume 30 percent of the risk in cases of economically conditioned losses and 20 percent of politically conditioned losses. The latter category includes the stoppage of foreign currency transfers imposed by the debtor country. In contrast, the risk assumed for losses caused by inability to convert currencies or by restrictions on the transfer of capital is only 5 percent for Dutch exporters, 10 percent for French, and 15 percent for Belgian and Italian exporters. The effect of these variations—and the inadequacy of the insurance in some respects—is that capital goods necessitating long-term financing may not be readily available for underdeveloped areas and that Belgian, German, and Italian exporters are at a considerable competitive disadvantage compared with other suppliers of the underdeveloped countries.¹⁵⁸ As the association of the territories becomes a reality, such problems will become more pressing.

IV. EFFECTS AND PROBLEMS OF THE ASSOCIATION

No discussion of the territories can ignore at least three of the major problems which association with the E.E.C. creates. The first of these results from the fact that so many of the territories have, or will have, attained independence since the Treaty was signed in March 1957. In a somewhat larger setting, the relationship of the territories to the other territories in the proposed Free Trade Area deserves mention. Finally, the objections raised by third countries, mainly the South American and Asian producers of tropical fruit, must be considered.

A. FUTURE ASSOCIATION OF INDEPENDENT COUNTRIES

The following countries must be mentioned under this heading, all of which give rise to substantially the same problem: (1) the African trusteeship territories which have gained independence, for example, Togo (which on April 27, 1960, became the Republic of Togoland) and Italian Somaliland (since July 1, 1960, a part of the Republic of Somalia); (2) Guinea, originally covered by the provisions relating to French West Africa, but which has now be-

¹⁵⁸ Cf. Anspach, *Die Finanzierung der Ausfuhr in die Entwicklungsländer*, 2 EUROPÄISCHE WIRTSCHAFT 235 ff. (1959). Cf. also, Reuss, *Die Rentabilität wirtschaftlicher Unternehmen in Entwicklungsländern*, id., at 258 ff.

come independent. Although some maintain that Guinea continues to be covered by the Treaty,¹⁵⁹ it seems probable that a new association would have to be negotiated; (3) the Republic of the Congo (formerly the Belgian Congo) which became independent on July 1, 1960; (4) the three republics of the Union of Central African Republics and the four of the Council of the Entente plus Gabon and Mauritania all of which are, or soon will be, independent; (5) independent countries like Tunisia, which were invited by "Declarations of Intention" to associate with the E.E.C.

Having become sovereign nations, the countries of the first four groups indicated above will probably no longer be bound by the Treaty. No provision in the Treaty envisions the situation of these countries, and the Member States are not in agreement as to the attitude to be adopted. The Community is inclined to follow a pragmatic approach and to maintain the *status quo ante* until a new regime of association can be elaborated. On the other hand, none of the Territories have apparently rejected the principle of association, while several have clearly and publicly indicated favorable positions.^{159a} Where it will be necessary to negotiate or renegotiate an association,¹⁶⁰ obvious problems arise. For instance, to what extent are the provisions of the Development Fund to apply, and to what extent does the inclusion of the products of these independent countries necessitate a re-examination of E.E.C. internal policy, for instance agricultural policy, and of E.E.C. external policy, for instance the common external tariff? More importantly, to what extent does the association of independent areas necessitate a change in the institutional structure of the E.E.C.? This point was raised as early as 1957 in the Belgian Parliament.¹⁶¹ The type and extent of these institutional changes will depend on the form of association. An association—for instance a free trade area between the E.E.C. and these areas—may be characterized by no institutional changes in the E.E.C.; any problems could be handled on an international inter-institutional level. On the other hand, if the association takes

¹⁵⁹ Metzger, *Probefall: Guinea—Assoziierung auch nach Erlangung der Souveränität*, 2 EUROPÄISCHE WIRTSCHAFT 255 ff. (1959).

^{159a} XXX., *La C.E.E. et les nouveaux États indépendants d'Afrique*, 1960 REVUE DU MARCHÉ COMMUN 253. Cf., also, Dale, *New Nations Pose Trade Question*, N.Y. Times, Oct. 11, 1960, 8:2.

¹⁶⁰ Preliminary contacts with Italian Somaliland have already been made. Press Bulletin EUROPE No. 484, item 2987, Aug. 26, 1959. Cf. also Resolution of the European Assembly of Nov. 27, 1959, paras. 4-6, [1959] J.O. 1267/59 at 1268/59.

¹⁶¹ Speech by Mr. Scheyven, Chambre des Représentants, *Annales*, Session of Nov. 14, 1957, 7.

the form of adhesion ¹⁶² to the E.E.C. Treaty some changes may be necessary. It would seem that representatives from these areas would have to be seated in the European Parliamentary Assembly (no longer being members of the contingent of the metropolitan country) ¹⁶³ and would have to participate in the work of the executive bodies of the Community. The latter would involve, for instance, a difficult re-examination of all provisions relating to weighted voting.

B. PROBLEMS IN CONNECTION WITH THE PROPOSED FREE TRADE AREA

The foregoing problems would, of course, be multiplied if the E.E.C. should become a part of a larger free trade area. Such an arrangement would presumably increase agricultural competition, due to the inclusion of European countries like Denmark and of overseas areas such as the British possessions in Africa. For instance, it is reported that under the present scheme of association of the Overseas Territories there exists a certain equilibrium in the production and consumption of coffee in the E.E.C.; in the case of a free trade area there may be an excess of 100,000 tons. With respect to cocoa, a deficit of 65,000 tons exists presently within the E.E.C., but a free trade area may bring an excess of 70,000 tons.¹⁶⁴

Other difficulties lie in the area of investments and French trade. It is doubtful for instance, that the countries of a free trade area would be able (in the case of Switzerland because of its neutrality) or willing (in the case of the United Kingdom, because of her own overseas commitments) to participate in the financing of the development of the E.E.C. Overseas Territories to the extent that increased competition would require. Yet, if they do not, some doubt that France could commit herself to accept the burdens of a free

¹⁶² The difference is mainly one of *associating* such an area under art. 238 or allowing it to *adhere* in a form analogous to art. 237. The latter provides only for *adhesion* by any *European* State. Yet, the extension of the Treaty to Algeria and the overseas departments of France, by art. 227 of the Treaty, is one case where the territorial principle is not followed. Institutional changes due to *adhesion* would thus become probable if any of the *departments* should gain independence but desire to maintain their present status in relation to the E.E.C.

¹⁶³ In 1959 the French contingent included three representatives from Algeria. Press Bulletin EUROPE, No. 376 Supp., April 2, 1959. For the structure and work of the Assembly, see Stein, *The European Parliamentary Assembly: Techniques of Emerging "Political Control,"* 13 INTERNATIONAL ORGANIZATION 233 ff. (1959).

¹⁶⁴ Representative Raingeard, Assemblée Parlementaire Européenne, *Compte rendu sténographique provisoire*, June 25, 1958, 9 (2d part), 162-163.

trade area in addition to those which her territories create.¹⁶⁵ Finally, as M. Diori, former overseas representative in the European Parliamentary Assembly, pointed out, any compromise with respect to the above problems has to give first priority to the political significance of the association of the E.E.C. territories. The Six have a political responsibility to support the economic, social, and political development of Africa and to further cooperation between Europe and Africa. This responsibility should not be ignored, however difficult it renders any mutually satisfactory solution to the free trade area problem.¹⁶⁶

C. THE OBJECTIONS OF THIRD COUNTRIES

Serious objections to the association of the territories were raised by Latin American and Asian countries, all of which are to a large extent suppliers of primary products and therefore most directly affected by the preference extended to the territories by the E.E.C. Objections were also raised by Britain and Portugal because of the disadvantageous position in which exports from their African territories have been placed.¹⁶⁷ Latin America exported 35.3 percent of its total coffee exports to Europe in 1954-1955.¹⁶⁸ A study of the United Nations Economic Commission for Latin America indicates gradual gains of African products in the E.E.C. market and comparable Latin American losses. The impact of the E.E.C. Treaty may accelerate this trend with a resulting weakening of international prices for Latin American commodities due to the characteristic inelasticity of demand for foodstuffs and tropical products, with a corresponding adverse effect on Latin American terms of trade.¹⁶⁹ The most recent report of the United Nations Economic Commission for Asia and the Far East shows the possible effect of the Treaty on those regions. Thus, Indonesia exports 43 percent of its total coffee exports to the Six; and 44 percent of the total tea exports of the Far East go to the Community. The Far East would also be affected with regard to its sugar, tobacco, and vegetable oil exports.

¹⁶⁵ *Ibid.* 161, 164.

¹⁶⁶ *Ibid.* 158

¹⁶⁷ Olyslager, *De Associatie der Overzeese Gebieden met de Europese Economische Gemeenschap*, 11 *ECONOMISCH EN SOCIAAL TIJDSCHRIFT*, 1 at 8 (1957). Cf. generally, OLYSLAGER, *DE ASSOCIATIE VAN DE OVERZEESE GEBIEDEN MET DE EUROPESE ECONOMISCHE GEMEENSCHAP* (1958).

¹⁶⁸ U.N. ECONOMIC COMMISSION FOR LATIN AMERICA, *Note by the Secretariat on the possible repercussions of the European Common Market on Latin American exports*, E/CN.12/449, 21 (1957).

¹⁶⁹ *Ibid.* 23.

Japan would be affected with regard to her exports of woolen, cotton, and rayon fabrics, medicines, and timber, and, in addition, would face stiffer competition in third markets.¹⁷⁰

These effects were analyzed by a recent G.A.T.T. study.¹⁷¹ It pointed out that the external tariff of the E.E.C. on tropical products—while it has the *effect* of a protective tariff in regard to the products of the associated territories—is, by nature, a revenue tariff since no tropical products are produced within the E.E.C. The result of the removal of these tariffs vis-à-vis the associated countries has a trade-diverting effect, it is argued, since it cannot displace high-cost production within the E.E.C. It is further argued that the trade-diverting effect of the association, that is, the diversion of trade away from traditional sources of supply to the associated territories, could only be countered by an increase in *total* imports from the outside, which would occur if imports from the associated territories increased to such an extent that they offset the displacement of imports from traditional sources.

The Six have consistently adopted the latter thesis to show that the association will not be trade-diverting, and have argued beyond this that the former suppliers will indeed benefit from an increase in demand.¹⁷² They foresee, for instance with regard to fats and vegetable oils, that imports from the associated countries will lower Community prices. Yet, since the *per capita* consumption of these products is far below that of the United States, increased demand for these products may be expected with an increased standard of living both in the Community and in the producing territories. For purposes of an examination of trade effects the exportable surplus, rather than total production, is therefore one criterion, and changing—especially increasing—patterns of consumption are another.¹⁷³ Finally, there is room for considerable doubt that the production of the Overseas Territories will increase appreciably as a result of the association and thus displace traditional imports. The solution of problems of soil erosion, irrigation, transport and labor will require years, perhaps decades before the exportable surplus can threaten to displace traditional sources of supply.¹⁷⁴ Thus, the posi-

¹⁷⁰ U.N. ECONOMIC COMMISSION FOR ASIA AND THE FAR EAST, *Economic Survey of Asia and the Far East* 1958, 42-43, 46 (1959).

¹⁷¹ G.A.T.T., TRENDS IN INTERNATIONAL TRADE, 119-121 (1958).

¹⁷² Cf. Report of the G.A.T.T. Working Party on Tropical Products, Press Bulletin EUROPE, Nos. 357-362, March 9-14, 1959.

¹⁷³ U.N., *supra* note 170 at 43.

¹⁷⁴ Jantzen, *Die Entwicklungspolitik in Afrika südlich der Sahara*, 2 EUROPÄISCHE WIRTSCHAFT 251 at 252 (1959).

tion of the Six in the G.A.T.T. negotiations is that the association will not prejudice traditional imports and that, in fact, it may be expected that third countries will, beyond this, also benefit from an appreciable share of the increase in demand in the E.E.C.

However, while they disclaim any of the disadvantageous effects asserted by third countries, the Six have already taken steps and issued policy statements which are intended to ensure that third countries will not suffer the feared adverse effects. To prevent short-term effects, the Six extended part of their first 10 percent tariff reduction (of January 1, 1959) to their O.E.E.C. and G.A.T.T. partners, as well as to those countries which enjoy most-favored-nation treatment.¹⁷⁵ In formulating long-term policy, the Six are also obligated by the Treaty to take into account the interests of third countries,¹⁷⁶ and the Treaty enables the Community to negotiate trade agreements.¹⁷⁷ In the meantime, the E.E.C. Council has already declared its willingness to work within G.A.T.T. towards a general lowering of trade barriers.

¹⁷⁵ U.N. Economic Commission for Asia and the Far East, *Report of the Committee on Trade*, E/CN.II/497 (E/CN.II/5), 1959, 17.

¹⁷⁶ Arts. 18, 110, 111(5).

¹⁷⁷ Art. 113.

Annex

European Free Trade Association Text of Convention and other Documents Approved at Stockholm on 20th November, 1959 *

I.—COMMUNIQUE ISSUED AT STOCKHOLM, 20TH NOVEMBER, 1959

On behalf of their Governments, Ministers from Austria, Denmark, Norway, Portugal, Sweden, Switzerland and the United Kingdom have today initialled at Stockholm the text of a Convention establishing the European Free Trade Association, to consist of the seven founding members together with any other countries which may accede to it.

The purposes of the Association are economic expansion, full employment, the rational use of resources, financial stability and a higher standard of living.

The Convention will establish a free market between the members of the Association. This will be achieved by the abolition of tariffs and other obstacles to trade in the industrial products of members over a period of ten years, or earlier if so decided. Each country will be free to decide its own external tariffs.

Freer trade between the participating countries will stimulate competition and economic expansion. There are provisions to ensure that the effects of the removal of the barriers to trade are not nullified by means of subsidies, practices of state undertakings, restrictive business practices and limitations to the establishment of enterprises.

The Convention also covers agricultural goods, for which special provisions are made and agreements concluded so as to promote expansion of trade and ensure a sufficient degree of reciprocity to the countries whose major exports are agricultural. To the same end

* Cmnd. 906, London.

there are also special rules for trade in non-processed fish and marine products.

The Convention reaffirms the determination of the seven member countries to facilitate the early establishment of a multilateral association for the removal of trade barriers and the promotion of closer economic co-operation between the members of the organisation for European Economic Co-operation, including the six members of the European Economic Community. To this end a special resolution was adopted.

As world trading nations, the countries of the European Free Trade Association are particularly conscious of Europe's links with the rest of the world. They have therefore chosen a form of economic co-operation which, while strengthening Europe, enables them to take full account of the interests of other trading countries throughout the world, including those facing special problems of development. The Association is a further expression of the post-war drive towards lower trade barriers, and reflects the principles which have been established by the General Agreement on Tariffs and Trade (G.A.T.T.). The individual freedom of action of E.F.T.A. members in their external tariffs will allow each of them to participate actively in G.A.T.T. negotiations for tariff reductions.

The Ministers were informed that the Finnish Government wished to discuss means by which they could participate in the arrangements planned by the E.F.T.A. and warmly welcomed this Finnish initiative.

The Convention establishes a Council charged with the supervision of the application of the Convention and the furtherance of its objectives. Pending ratification of the Convention the Committee of senior officials remains in being to ensure the closest contact between member governments on all matters of major importance arising out of the Association. A Preparatory Committee has been established to develop the institutions of E.F.T.A.

It was agreed to seek ratification of the Convention not later than March 31st, 1960.

II.—RESOLUTION

For more than 10 years, the seven countries which are now establishing the European Free Trade Association, have co-operated most successfully within the framework of the O.E.E.C. both with the six countries which are Members of the European Economic Community, and with Greece, Ireland, Iceland, Turkey and recently Spain.

Indeed the remarkable expansion of the European economy since the end of the war is due, to a large extent, to the work of the O.E.E.C. Its achievements have had beneficial effects far beyond Europe. By preparing the convertibility of currencies, the O.E.E.C. has created the conditions permitting its members to eliminate the restrictions on trade progressively also toward third countries. By promoting freer trade in Europe, the O.E.E.C. plays therefore an important role in the liberalisation of trade on a world-wide basis.

The existence of two groups, the European Free Trade Association and the European Economic Community, inspired by different but not incompatible principles, implies the risk that further progress along these lines be hampered, if such a danger could not be avoided by an agreement to which all countries interested in European economic co-operation could subscribe.

Such an agreement, based on the principle of reciprocity, should not cause any damage to the measures taken by the European Free Trade Association and the European Economic Community. Moreover, it should allow member States of either organisation to eliminate in common the obstacles to trade between them, and more generally, to seek to solve the problems they share. Among those, there is the problem of aiding the less developed countries in Europe and in other continents, which is one of the foremost tasks of the more advanced countries.

Common action in these fields would strengthen the already existing bonds between the European countries as well as the solidarity arising from their common destiny, even if their views on the way in which European integration should be achieved are not always identical.

For these reasons, the seven Governments who will sign the Convention establishing the European Free Trade Association, declare their determination to do all in their power to avoid a new division in Europe. They regard their Association as a step toward an agreement between all member countries of O.E.E.C.

To this end the seven Governments are ready to initiate negotiations with the members of the E.E.C. as soon as they are prepared to do so. Meanwhile views should be exchanged through diplomatic channels or in any other way, on the basis upon which such negotiations may profitably be opened.

Stockholm, November 20, 1959.

III.—CONVENTION ESTABLISHING THE EUROPEAN FREE TRADE ASSOCIATION

*(Text as initialled by Ministers at Stockholm on 20th
November, 1959)*

The Republic of Austria, the Kingdom of Denmark, the Kingdom of Norway, the Portuguese Republic, the Kingdom of Sweden, the Swiss Confederation and the United Kingdom of Great Britain and Northern Ireland:

Having regard to the Convention for European Economic Co-operation of 16th April, 1948, which established the Organisation for European Economic Co-operation;

Resolved to maintain and develop the co-operation instituted within that Organisation;

Determined to facilitate the early establishment of a multilateral association for the removal of trade barriers and the promotion of closer economic co-operation between the Members of the Organisation for European Economic Co-operation, including the Members of the European Economic Community;

Having regard to the General Agreement on Tariffs and Trade;

Resolved to promote the objectives of that Agreement;

Have agreed as follows:

ARTICLE 1

The Association

1. An international organisation to be known as the European Free Trade Association, hereinafter referred to as "the Association," is hereby established.

2. The Members of the Association, hereinafter referred to as "Member States," shall be the States which ratify this Convention and such other States as may accede to it.

3. The Area of the Association shall be the territories to which this Convention applies.

4. The Institutions of the Association shall be a Council and such other organs as the Council may set up.

ARTICLE 2

Objectives

The objectives of the Association shall be:

- (a) to promote in the Area of the Association and in each Member State a sustained expansion of economic activity, full employment, increased productivity and the rational use of

resources, financial stability and continuous improvement in living standards,

- (b) to secure that trade between Member States takes place in conditions of fair competition,
- (c) to avoid significant disparity between Member States in the conditions of supply of raw materials produced within the Area of the Association, and
- (d) to contribute to the harmonious development and expansion of world trade and to the progressive removal of barriers to it.

ARTICLE 3

Import duties

1. Member States shall reduce and ultimately eliminate, in accordance with this Article, customs duties and any other charges with equivalent effect, except duties notified in accordance with Article 6 and other charges which fall within that Article, imposed on or in connexion with the importation of goods which are eligible for Area tariff treatment in accordance with Article 4. Any such duty or other charge is hereinafter referred to as an "import duty."

2. (a) On and after each of the following dates, Member States shall not apply an import duty on any product at a level exceeding the percentage of the basic duty specified against that date:

1st July, 1960	80 percent
1st January, 1962	70 percent
1st July, 1963	60 percent
1st January, 1965	50 percent
1st January, 1966	40 percent
1st January, 1967	30 percent
1st January, 1968	20 percent
1st January, 1969	10 percent

(b) On and after 1st January, 1970, Member States shall not apply any import duties.

3. Subject to Annex A, the basic duty referred to in paragraph 2 of this Article is, in respect of each Member State and in respect of any product, the import duty applied by that Member State to the imports of that product from other Member States on 1st January, 1960.

4. Each Member State declares its willingness to apply import duties at a level below that indicated in paragraph 2 of this Article

if it considers that its economic and financial position and the position of the sector concerned so permit.

5. The Council may at any time decide that any import duties shall be reduced more rapidly or eliminated earlier than is provided in paragraph 2 of this Article. Between 1st July, 1960, and 31st December, 1961, the Council shall examine whether it is possible so to decide in respect of import duties applied on some or all goods by some or all of the Member States.

ARTICLE 4

Area tariff treatment

1. For the purposes of Articles 3 to 7, goods shall, subject to Annex B, be accepted as eligible for Area tariff treatment if they have been consigned to the territory of the importing Member State from the territory of another Member State and if they are of Area origin under any one of the following conditions:

- (a) that they have been wholly produced within the Area of the Association;
- (b) that they fall within a description of goods listed in the Process Lists which form Schedules I and II to Annex B and have been produced within the Area of the Association by the appropriate qualifying process described in those Lists;
- (c) that in the case of goods other than those listed in Schedule II to Annex B, they have been produced within the Area of the Association, and that the value of any materials imported from outside the Area or of undetermined origin which have been used at any stage of the production of the goods does not exceed 50 percent of the export price of the goods.

2. For the purposes of sub-paragraphs (a), (b) and (c) of paragraph 1 of this Article, materials listed in the Basic Materials List which forms Schedule III to Annex B which have been used in the state described in that List in a process of production within the Area of the Association shall be deemed to contain no element imported from outside the Area.

3. Nothing in this Convention shall prevent a Member State from accepting as eligible for Area tariff treatment any goods imported from the territory of another Member State, provided that the like goods imported from the territory of any Member State are accorded the same treatment.

4. Provisions necessary for the administration and effective application of this Article are contained in Annex B.

5. The Council may decide to amend the provisions of this Article and of Annex B.

6. The Council shall from time to time examine in what respect this Convention can be amended in order to ensure the smooth operation of the origin rules and especially to make them simpler and more liberal.

ARTICLE 5

Deflection of trade

1. For the purposes of this Article, trade is said to be deflected when

(a) imports of a particular product into the territory of a Member State from the territory of another Member State are increasing,

(i) as a result of the reduction or elimination in the importing Member State of duties and charges on that product in accordance with Article 3 or 6, and

(ii) because the duties or charges levied by the exporting Member State on imports of raw materials or intermediate products, used in the production of the product in question, are significantly lower than the corresponding duties or charges levied by the importing Member State, and

(b) this increase in imports causes or would cause serious injury to production which is carried on in the territory of the importing Member State.

2. The Council shall keep under review the question of deflections of trade and their causes. It shall take such decisions as are necessary in order to deal with the causes of deflection of trade by amending the rules of origin in accordance with paragraph 5 of Article 4 or by such other means as it may consider appropriate.

3. If a deflection of trade of a particularly urgent nature occurs, any Member State may refer the matter to the Council. The Council shall take its decision as quickly as possible, and, in general, within one month. The Council may, by majority decision, authorise interim measures to safeguard the position of the Member State in question. Such measures shall not continue for longer than is necessary for the procedure under paragraph 2 above to take place, and for not more than two months, unless, in exceptional cases, the Council, by majority decision, authorises an extension of this period by not more than two months.

4. A Member State which is considering the reduction of the ef-

fective level of its duties or charges on any product not eligible for Area tariff treatment shall, as far as may be practicable, notify the Council not less than thirty days before such reduction comes into effect, and shall consider any representations by other Member States that the reduction is likely to lead to a deflection of trade. Information received under this paragraph shall not be disclosed to any person outside the service of the Association or the Government of any Member State.

5. When considering changes in their duties or charges on any product not eligible for Area tariff treatment, Member States shall have due regard to the desirability of avoiding consequential deflections of trade. In such cases, any Member State which considers that trade is being deflected may refer the matter to the Council in accordance with Article 31.

6. If, in the consideration of any complaint in accordance with Article 31, reference is made to a difference in the level of duties or charges on any product not eligible for Area tariff treatment, that difference shall be taken into account only if the Council finds by majority vote that there is a deflection of trade.

7. The Council shall review from time to time the provisions of this Article and may decide to amend those provisions.

ARTICLE 6

Revenue duties and internal taxation

1. Member States shall not

- (a) apply directly or indirectly to imported goods any fiscal charges in excess of those applied directly or indirectly to like domestic goods, nor otherwise apply such charges so as to afford effective protection to like domestic goods, or
- (b) apply fiscal charges to imported goods of a kind which they do not produce, or which they do not produce in substantial quantities, in such a way as to afford effective protection to the domestic production of goods of a different kind which are substitutable for the imported goods, which enter into direct competition with them and which do not bear directly or indirectly, in the country of importation, fiscal charges of equivalent incidence,

and shall give effect to these obligations in the manner laid down in paragraphs 2 and 3 of this Article.

2. Member States shall not introduce new fiscal charges which are inconsistent with paragraph 1 of this Article, and shall not vary an existing fiscal charge in such a way as to increase, above the level

in force on the date by reference to which the basic duty is determined in accordance with paragraph 3 of Article 3, any effective protective element in the fiscal charge, that is to say, the extent to which that charge is inconsistent with paragraph 1 of this Article.

3. (a) In the case of any internal tax or other internal charge, Member States shall eliminate any effective protective element on or before 1st January, 1962.

(b) In the case of any revenue duty, Member States shall either

(i) progressively eliminate any effective protective element in the duty by successive reductions corresponding to those prescribed for import duties in Articles 3, or

(ii) eliminate any effective protective element in the duty on or before 1st January, 1965.

(c) Each Member State shall, on or before 1st July, 1960, notify to the Council any duty to which it will apply the provisions of sub-paragraph (b) (ii) of this paragraph.

4. Each Member State shall notify to the Council all fiscal charges applied by it where the rates of charge, or the conditions governing the imposition or collection of the charge, are not identical in relation to the imported goods and to the like domestic goods, as soon as the Member State applying the charge considers that the charge is, or has been made, consistent with sub-paragraph (a) of paragraph 1 of this Article. Each Member State shall, at the request of any other Member State, supply information about the application of paragraphs 1, 2 and 3 of this Article.

5. Each Member State shall notify to the Council the revenue duties to which it intends to apply the provisions of this Article.

6. For the purposes of this Article:

(a) "fiscal charges" means revenue duties, internal taxes and other internal charges on goods;

(b) "revenue duties" means customs duties and other similar charges applied primarily for the purpose of raising revenue;

(c) "imported goods" means goods which are accepted as being eligible for Area tariff treatment in accordance with the provisions of Article 4.

ARTICLE 7

Drawback

1. Each Member State may, on and after 1st January, 1970, refuse to accept as eligible for Area tariff treatment goods which benefit from drawback allowed by Member States in the territory of

which the goods have undergone the processes of production which form the basis of the claim that the goods in question are of Area origin. In applying this paragraph, each Member State shall accord the same treatment to imports from the territories of all Member States.

2. Similar provisions shall apply to drawback in respect of imported materials of the kinds listed in Annex D and in Annex E.

3. Before 31st December, 1960, the Council shall decide what provisions are to be applied to deal with drawback in the period after 31st December, 1961, and before 1st January, 1970.

4. The Council may at any time after their decision under paragraph 3 consider whether further or different provisions are necessary to deal with drawback after 31st December, 1961, and may decide that such provisions are to be applied.

5. For the purposes of this Article:

- (a) "drawback" means any arrangement for the refund or remission, wholly or in part, of duties applicable to imported materials, provided that the arrangement, expressly or in effect, allows refund or remission if certain goods or materials are exported, but not if they are retained for home use;
- (b) "remission" includes exemption for materials brought into free ports and other places which have similar customs privileges;
- (c) "duties" means (i) all charges on or in connection with importation, except the fiscal charges to which Article 6 applies and (ii) any protective element in such fiscal charges;
- (d) "materials" and "process of production" have the meanings assigned to them in Rule 1 of Annex B.

ARTICLE 8

Prohibition of export duties

1. Member States shall not introduce or increase export duties, and, on and after 1st January, 1962, shall not apply any such duties.

2. The provisions of this Article shall not prevent any Member State from taking such measures as are necessary to prevent evasion, by means of re-export, of duties which it applies to exports to territories outside the Area of the Association.

3. For the purposes of this Article, "export duties" means any duties or charges with equivalent effect, imposed on or in connection with the exportation of goods from the territory of any Member State to the territory of any other Member State.

ARTICLE 9

Co-operation in customs administration

Member States shall take appropriate measures, including arrangements regarding administrative co-operation, to ensure that the provisions of Articles 3 to 7 and of Annexes A and B are effectively and harmoniously applied, taking account of the need to reduce as far as is possible the formalities imposed on trade and of the need to achieve mutually satisfactory solutions of any difficulties arising out of the operation of those provisions.

ARTICLE 10

Quantitative import restrictions

1. Member States shall not introduce or intensify quantitative restrictions on imports of goods from the territory of other Member States.

2. Member States shall eliminate such quantitative restrictions as soon as possible and not later than 31st December, 1969.

3. Each Member State shall relax quantitative restrictions progressively and in such a way that a reasonable rate of expansion of trade as a result of the application of Articles 3 and 6 is not frustrated and that no burdensome problems are created for the Member State concerned in the years immediately preceding 1st January, 1970.

4. Each Member State shall apply the provisions of this Article in such a way that all other Member States are given like treatment.

5. On 1st July, 1960, Member States shall establish for all goods subject to quantitative restriction global quotas of a size not less than 20 percent above the corresponding basic quotas. In the case of quotas which may be available also to States which are not Members, the global quotas shall include, in addition to the basic quotas increased by not less than 20 percent, an amount not less than the total of the imports from such States in the calendar year 1959.

6. If a basic quota is nil or negligible, Member States shall ensure that the quota to be established on 1st July, 1960, is of appropriate size. Before or after the establishment of any such quota, any Member State may initiate consultations about its appropriate size.

7. On 1st July, 1961, and on 1st July in each succeeding year, Member States shall increase each quota established in accordance with paragraphs 5 and 6 of this Article by not less than 20 percent of an amount equivalent to the basic quota as already increased pursuant to this Article.

8. If any Member State considers that the application of para-

graphs 5 to 7 of this Article to a product would cause it serious difficulties, that Member State may propose to the Council alternative arrangements for that product. The Council may, by majority decision, authorise that Member State to adopt such alternative arrangements as the Council considers appropriate.

9. Member States shall notify to the Council details of the quotas established in accordance with the provisions of this Article.

10. The Council shall, not later than 31st December, 1961, and from time to time thereafter, review the provisions of this Article and the progress made by Member States in the application of its provisions, and may decide that further or different provisions are to be applied.

11. For the purposes of this Article:

- (a) "quantitative restrictions" means prohibitions or restrictions on imports from the territory of other Member States whether made effective through quotas, import licences or other measures with equivalent effect, including administrative measures and requirements restricting import;
- (b) "basic quota" means any quota or the total of any quotas which have been established, together with the total of any imports which are otherwise subject to quantitative restriction, in respect of goods imported from the territory of other Member States in the calendar year 1959; or in the case of global quotas which are open to States which are not Members, the total of the imports under such quotas from Member States in the calendar year 1959;
- (c) "global quota" means a quota under which licences or other authorities to import allow the holders to import any of the products covered by quota from all Member States and other States to which the quota applies.

ARTICLE 11

Quantitative export restrictions

1. Member States shall not introduce or intensify prohibitions or restrictions on exports to other Member States, whether made effective through quotas or export licences or other measures with equivalent effect, and shall eliminate any such prohibitions or restrictions not later than 31st December, 1961.

2. The provisions of this Article shall not prevent any Member State from taking such measures as are necessary to prevent evasion, by means of re-export, of restrictions which it applies to exports to territories outside the Area of the Association.

ARTICLE 12

Exceptions

Provided that such measures are not used as a means of arbitrary or unjustifiable discrimination between Member States, or as a disguised restriction on trade between Member States, nothing in Articles 10 and 11 shall prevent the adoption or enforcement by any Member State of measures,

- (a) necessary to protect public morals,
- (b) necessary for the prevention of disorder or crime,
- (c) necessary to protect human, animal or plant life or health,
- (d) necessary to secure compliance with laws or regulations relating to customs enforcement, or to the classification, grading or marketing of goods, or to the operation of monopolies by means of state enterprises or enterprises given exclusive or special privileges,
- (e) necessary to protect industrial property or copyrights or to prevent deceptive practices,
- (f) relating to gold or silver,
- (g) relating to the products of prison labour, or
- (h) imposed for the protection of national treasures of artistic, historic or archaeological value.

ARTICLE 13

Government aids

1. Member States shall not maintain or introduce

- (a) the forms of aid to exports of goods to other Member States which are described in Annex C, or
- (b) any other form of aid, the main purpose or effect of which is to frustrate the benefits expected from the removal or absence of duties and quantitative restrictions on trade between Member States.

2. If the application of any form of aid by a Member State, although not contrary to paragraph 1 of this Article, frustrates the benefits expected from the removal or absence of duties and quantitative restrictions on trade between Member States and provided that the procedure set out in paragraphs 1 to 3 of Article 31 has been followed, the Council may, by majority decision, authorise any Member State to suspend to the Member State which is applying the aid, the application of such obligations under this Convention as the Council considers appropriate.

3. The Council may decide to amend the provisions of this Article and of Annex C.

ARTICLE 14

Public undertakings

1. Member States shall ensure the progressive elimination, during the period from 1st July, 1960, to 31st December, 1969, in the practices of public undertakings, of

- (a) measures the effect of which is to afford protection to domestic production which would be inconsistent with this Convention if achieved by means of a duty or charge with equivalent effect, quantitative restriction or Government aid, or
- (b) trade discrimination on grounds of nationality in so far as it frustrates the benefits expected from the removal or absence of duties and quantitative restrictions on trade between Member States.

2. In so far as the provisions of Article 15 are relevant to the activities of public undertakings, that Article shall apply to them in the same way as it applies to other enterprises.

3. Member States shall ensure that new practices of the kind described in paragraph 1 of this Article are not introduced.

4. Where Member States do not have the necessary legal powers to control the activities of regional or local government authorities or enterprises under their control in these matters, they shall nevertheless endeavour to ensure that those authorities or enterprises comply with the provisions of this Article.

5. The Council shall keep the provisions of this Article under review and may decide to amend them.

6. For the purposes of this Article, "public undertakings" means central, regional, or local government authorities, public enterprises and any other organisation by means of which a Member State, by law or in practice, controls or appreciably influences imports from, or exports to, the territory of a Member State.

ARTICLE 15

Restrictive business practices

1. Member States recognise that the following practices are incompatible with this Convention in so far as they frustrate the benefits expected from the removal or absence of duties and quantitative restrictions on trade between Member States:

- (a) agreements between enterprises, decisions by associations of enterprises and concerted practices between enterprises which have as their object or result the prevention, restriction or distortion of competition within the Area of the Association;

(b) actions by which one or more enterprises take unfair advantage of a dominant position within the Area of the Association or a substantial part of it.

2. If any practice of the kind described in paragraph 1 of this Article is referred to the Council in accordance with Article 31, the Council may, in any recommendation in accordance with paragraph 3 or in any decision in accordance with paragraph 4 of that Article, make provision for publication of a report on the circumstances of the matter.

3. (a) In the light of experience gained, the Council shall consider not later than 31st December, 1964, and may consider at any time thereafter, whether further or different provisions are necessary to deal with the effects of restrictive business practices or dominant enterprises on trade between Member States.

(b) Such review shall include consideration of the following matters:

- (i) specification of the restrictive business practices or dominant enterprises with which the Council should be concerned;
- (ii) methods of securing information about restrictive business practices or dominant enterprises;
- (iii) procedures for investigations;
- (iv) whether the right to initiate inquiries should be conferred on the Council.

(c) The Council may decide to make the provisions found necessary as a result of the review envisaged in sub-paragraphs (a) and (b) of this paragraph.

ARTICLE 16 Establishment

1. Member States recognise that restrictions on the establishment and operation of economic enterprises in their territories by nationals of other Member States should not be applied, through accord to such nationals of treatment which is less favourable than that accorded to their own nationals in such matters, in such a way as to frustrate the benefits expected from the removal or the absence of duties and quantitative restrictions on trade between Member States.

2. Member States shall not apply new restrictions in such a way that they conflict with the principle set out in paragraph 1 of this Article.

3. Member States shall notify the Council, within such period as

the Council may decide, of particulars of any restrictions which they apply in such a way that nationals of another Member State are accorded in their territories less favourable treatment in respect of the matters set out in paragraph 1 of this Article than is accorded to their own nationals.

4. The Council shall consider not later than 31st December, 1964, and may consider at any time thereafter, whether further or different provisions are necessary to give effect to the principles set out in paragraph 1 of this Article, and may decide to make the necessary provisions.

5. Nothing in this Article shall prevent the adoption and enforcement by a Member State of measures for the control of entry, residence, activity and departure of aliens where such measures are justified by reasons of public order, public health or morality, or national security, or for the prevention of a serious imbalance in the social or demographic structure of that Member State.

6. For the purposes of this Article:

- (a) "nationals" means, in relation to a Member State,
 - (i) physical persons who have the nationality of that Member State and
 - (ii) companies and other legal persons constituted in the territory of that Member State in conformity with the law of that State and which that State regards as having its nationality, provided that they have been formed for gainful purposes and that they have their registered office and central administration, and carry on substantial activity, within the Area of the Association;
- (b) "economic enterprises" means any type of economic enterprise for production of or commerce in goods which are of Area origin, whether conducted by physical persons or through agencies, branches or companies or other legal persons.

ARTICLE 17

Dumped and subsidised imports

1. Nothing in this Convention shall prevent any Member State from taking action against dumped or subsidised imports consistently with its other international obligations.

2. Any products which have been exported from the territory of one Member State to the territory of another Member State and

have not undergone any manufacturing process since exportation shall, when reimported into the territory of the first Member State, be admitted free of quantitative restrictions and measures with equivalent effect. They shall also be admitted free of customs duties and charges with equivalent effect, except that any allowance by way of drawback, relief from duty or otherwise, given by reason of the exportation from the territory of the first Member State, may be recovered.

3. If any industry in the territory of any Member State is suffering or is threatened with material injury as the result of the import of dumped or subsidised products into the territory of another Member State, the latter Member State shall, at the request of the former Member State, examine the possibility of taking such action as is consistent with its international obligations to remedy the injury or prevent the threatened injury.

ARTICLE 18

Security exceptions

1. Nothing in this Convention shall prevent any Member State from taking action which it considers necessary for the protection of its essential security interests, where such action

- (a) is taken to prevent the disclosure of information,
- (b) relates to trade in arms, ammunition or war materials or to research, development or production indispensable for defence purposes, provided that such action does not include the application of import duties or the quantitative restriction of imports except in so far as such restriction is permitted in accordance with Article 12 or is authorised by decision of the Council,
- (c) is taken to ensure that nuclear materials and equipment made available for peaceful purposes do not further military purposes, or
- (d) is taken in time of war or other emergency in international relations.

2. Nothing in this Convention shall prevent any Member State from taking action to carry out undertakings into which that Member State has entered for the purpose of maintaining international peace and security.

ARTICLE 19

Balance of payments difficulties

1. Notwithstanding the provisions of Article 10, any Member

State may, consistently with its other international obligations, introduce quantitative restrictions on imports for the purpose of safeguarding its balance of payments.

2. Any Member State taking measures in accordance with paragraph 1 of this Article shall notify them to the Council, if possible before they come into force. The Council shall examine the situation and keep it under review and may at any time by majority vote, make recommendations designed to moderate any damaging effect of these restrictions or to assist the Member State concerned to overcome its difficulties. If the balance of payments difficulties persist for more than 18 months and the measures applied seriously disturb the operation of the Association, the Council shall examine the situation and may, taking into account the interests of all Member States, by majority decision, devise special procedures to attenuate or compensate for the effect of such measures.

3. A Member State which has taken measures in accordance with paragraph 1 of this Article shall have regard to its obligation to resume the full application of Article 10 and shall, as soon as its balance of payments situation improves, make proposals to the Council on the way in which this should be done. The Council, if it is not satisfied that these proposals are adequate, may, by majority vote, recommend to the Member State alternative arrangements to the same end.

ARTICLE 20

Difficulties in particular sectors

1. If, in the territory of a Member State,

- (a) an appreciable rise in unemployment in a particular sector of industry or region is caused by a substantial decrease in internal demand for a domestic product, and
- (b) this decrease in demand is due to an increase in imports from the territory of other Member States as a result of the progressive elimination of duties, charges and quantitative restrictions in accordance with Articles 3, 6 and 10,

that Member State may, notwithstanding any other provisions of this Convention,

- (i) limit those imports by means of quantitative restrictions to a rate not less than the rate of such imports during any period of twelve months which ended within twelve months of the date on which the restrictions come into force; the restrictions shall not be continued for a period longer than eighteen months, unless the

Council, by majority decision, authorises their continuance for such further period and on such conditions as the Council considers appropriate; and

- (ii) take such measures, either instead of or in addition to restriction of imports in accordance with sub-paragraph (i) of this paragraph, as the Council may, by majority decision, authorise.

2. In applying measures in accordance with paragraph 1 of this Article, a Member State shall give like treatment to imports from the territory of all Member States.

3. A Member State applying restrictions in accordance with sub-paragraph (i) of paragraph 1 of this Article shall notify them to the Council, if possible before they come into force. The Council may at any time consider those restrictions and may, by majority vote, make recommendations designed to moderate any damaging effect of those restrictions or to assist the Member State concerned to overcome its difficulties.

4. If at any time after 1st July, 1960, a Member State considers that the application of sub-paragraph (a) of paragraph 2 of Article 3 and paragraph 3 of Article 6 to any product would lead to the situation described in paragraph 1 of this Article, it may propose to the Council an alternative rate of reduction of the import duty or protective element concerned. If the Council finds that the proposal is justified, it may, by majority decision, authorise that Member State to apply an alternative rate of reduction, provided that the obligations relating to the final elimination of the import duty or protective element in accordance with sub-paragraph (b) of paragraph 2 of Article 3 and paragraph 3 of Article 6 are fulfilled.

5. Before 1st January, 1970, if the Council considers that some provision similar to those in paragraphs 1 to 3 of this Article will be required thereafter, it may decide that such provisions shall have effect for any period after that date.

ARTICLE 21

Agricultural goods

1. In view of the special considerations affecting agriculture the provisions in all the foregoing Articles of this Convention, except Articles 1 and 17, shall not apply in relation to the agricultural goods which are listed in Annex D. The Council may decide to amend the provisions of this paragraph and Annex D.

2. The special provisions which shall apply in relation to those agricultural goods are set out in Articles 22 to 25.

ARTICLE 22

Agricultural policies and objective

1. In regard to agriculture, Member States recognise that the policies pursued by them are designed

- (a) to promote increased productivity and the rational and economic development of production,
- (b) to provide a reasonable degree of market stability and adequate supplies to consumers at reasonable prices, and
- (c) to ensure an adequate standard of living to persons engaged in agriculture.

In pursuing these policies, Member States shall have due regard to the interests of other Member States in the export of agricultural goods and shall take into consideration traditional channels of trade.

2. Having regard to these policies, the objective of the Association shall be to facilitate an expansion of trade which will provide reasonable reciprocity to Member States whose economies depend to a great extent on exports of agricultural goods.

ARTICLE 23

Agricultural agreements between Member States

1. In pursuit of the objective set out in paragraph 2 of Article 22 and as a foundation for their co-operation in respect of agriculture, certain Member States have concluded agreements setting out measures to be taken, including the elimination of customs duties on some agricultural goods, in order to facilitate the expansion of trade in agricultural goods. In so far as any two or more Member States may at a later date conclude such agreements, they shall inform the other Member States before the agreements take effect.

2. Agreements concluded in accordance with paragraph 1 of this Article, and any agreement modifying these agreements which is made by the parties to them, shall remain in force as long as this Convention. Copies of such agreements shall be transmitted immediately after signature to the other Member States, and a certified copy shall be deposited with the Government of Sweden.

3. Any provisions regarding tariffs contained in such agreements shall apply in favour of all other Member States, and the benefit of those provisions shall not, as a result of any modification, be withdrawn from Member States without the consent of all of them.

ARTICLE 24

Export subsidies on agricultural goods

1. A Member State shall not cause damage to the interests of

other Member States by granting directly or indirectly any subsidy on a product listed in Annex D which results in an increase of that Member State's exports of that product compared with the exports which that Member State had in the product in question in a recent representative period.

2. It shall be the object of the Council, before 1st January, 1962, to establish rules for the gradual abolition of subsidised exports detrimental to other Member States.

3. The exemption of an exported product from duties, taxes or other charges borne by the like product when destined for domestic consumption or the remission of such duties, taxes or other charges in amounts not in excess of those which have accrued, shall not be deemed to be a subsidy for the purpose of this Article.

ARTICLE 25

Consultations on trade in agricultural goods

The Council shall keep the provisions of Articles 21 to 25 under review, and it shall once a year consider the development of trade in agricultural goods within the Area of the Association. The Council shall consider what further action shall be taken in pursuit of the objective set out in Article 22.

ARTICLE 26

Fish and other marine products

1. The provisions in all the foregoing Articles of this Convention, except Articles 1 and 17, shall not apply in relation to the fish and other marine products which are listed in Annex E. The special provisions which shall apply to those fish and other marine products are set out in Articles 27 and 28.

2. The Council may decide to delete products from the list contained in Annex E.

ARTICLE 27

Objective for trade in fish and other marine products

Having regard to the national policies of Member States and the special conditions prevailing in the fishing industry, the objective of the Association shall be to facilitate an expansion of trade in fish and other marine products which will provide reasonable reciprocity to Member States whose economies depend to a great extent on exports of those products.

ARTICLE 28

Trade in fish and other marine products

The Council shall before 1st January, 1961, begin an examination

of arrangements relating to trade in products listed in Annex E having regard to the objective set out in Article 27. This examination shall be concluded before 1st January, 1962.

ARTICLE 29

Invisible transactions and transfers

Member States recognise the importance of invisible transactions and transfers for the proper functioning of the Association. They consider that the obligations with regard to the freedom of such transactions and transfers undertaken by them in other international organisations are sufficient at present. The Council may decide on such further provisions with regard to such transactions and transfers as may prove desirable, having due regard to the wider international obligations of Member States.

ARTICLE 30

Economic and financial policies

Member States recognise that the economic and financial policies of each of them affect the economies of other Member States and intend to pursue those policies in a manner which serves to promote the objectives of the Association. They shall periodically exchange views on all aspects of those policies. In so doing, they shall take into account the corresponding activities within the Organisation for European Economic Co-operation and other international organisations. The Council may make recommendations to Member States on matters relating to those policies to the extent necessary to ensure the attainment of the objectives and the smooth operation of the Association.

ARTICLE 31

General consultations and complaints procedure

1. If any Member State considers that any benefit conferred upon it by this Convention or any objective of the Association is being or may be frustrated and if no satisfactory settlement is reached between the Member States concerned, any of those Member States may refer the matter to the Council.

2. The Council shall promptly, by majority vote, make arrangements for examining the matter. Such arrangements may include a reference to an examining committee constituted in accordance with Article 33. Before taking action under paragraph 3 of this Article, the Council shall so refer the matter at the request of any Member State concerned. Member States shall furnish all information which they can make available and shall lend their assistance to establish the facts.

3. When considering the matter, the Council shall have regard to whether it has been established that an obligation under the Convention has not been fulfilled, and whether and to what extent any benefit conferred by the Convention or any objective of the Association is being or may be frustrated. In the light of this consideration and of the report of any examining committee which may have been appointed, the Council may, by majority vote, make to any Member State such recommendations as it considers appropriate.

4. If a Member State does not or is unable to comply with a recommendation made in accordance with paragraph 3 of this Article and the Council finds, by majority vote, that an obligation under this Convention has not been fulfilled, the Council may, by majority decision, authorise any Member State to suspend to the Member State which has not complied with the recommendation the application of such obligations under this Convention as the Council considers appropriate.

5. Any Member State may, at any time while the matter is under consideration, request the Council to authorise, as a matter of urgency, interim measures to safeguard its position. If it appears to the Council that the circumstances are sufficiently serious to justify interim action, and without prejudice to any action which it may subsequently take in accordance with the preceding paragraphs of this Article, the Council may, by majority decision, authorise a Member State to suspend its obligations under this Convention to such an extent and for such a period as the Council considers appropriate.

ARTICLE 32

The Council

1. It shall be the responsibility of the Council
 - (a) to exercise such powers and functions as are conferred upon it by this Convention,
 - (b) to supervise the application of this Convention and keep its operation under review,
 - (c) to consider whether further action should be taken by Member States in order to promote the attainment of the objectives of the Association and to facilitate the establishment of closer links with other States, unions of States or international organisations.
2. Each Member State shall be represented in the Council and shall have one vote.
3. The Council may decide to set up such organs, committees and

other bodies as it considers necessary to assist it in accomplishing its tasks.

4. In exercising its responsibility under paragraph 1 of this Article, the Council may take decisions which shall be binding on all Member States and may make recommendations to Member States.

5. Decisions and recommendations of the Council shall be made by unanimous vote, except in so far as this Convention provides otherwise. Decisions or recommendations shall be regarded as unanimous unless any Member State casts a negative vote. Decisions and recommendations which are to be made by majority vote require the affirmative vote of four Member States.

6. If the number of the Member States changes, the Council may decide to amend the number of votes required for decisions and recommendations which are to be made by majority vote.

ARTICLE 33

Examining committees

The Examining Committees referred to in Article 31 shall consist of persons selected for their competence and integrity, who, in the performance of their duties, shall neither seek nor receive instructions from any State, or from any authority or organisation other than the Association. They shall be appointed by the Council on such terms and conditions as it shall decide.

ARTICLE 34

Administrative arrangements of the Association

The Council shall take decisions for the following purposes:

- (a) to lay down the Rules of Procedure of the Council and of any bodies of the Association, which may include provision that procedural questions may be decided by majority vote;
- (b) to make arrangements for the Secretariat services required by the Association;
- (c) to establish the financial arrangements necessary for the administrative expenses of the Association, the procedure for establishing a budget and the apportionment of those expenses between the Member States.

ARTICLE 35

Legal capacity, privileges and immunities

1. The legal capacity, privileges and immunities to be recognised and granted by the Member States in connection with the Association shall be laid down in a Protocol to this Convention.

2. The Council, acting on behalf of the Association, may conclude with the Government of the State in whose territory the head-

quarters will be situated an agreement relating to the legal capacity and the privileges and immunities to be recognized and granted in connection with the Association.

ARTICLE 36

Relations with international organisations

The Council, acting on behalf of the Association, shall seek to establish such relationships with other international organisations as may facilitate the attainment of the objectives of the Association. It shall in particular seek to establish close collaboration with the Organisation for European Economic Co-operation.

ARTICLE 37

Obligations under other international agreements

Nothing in this Convention shall be regarded as exempting any Member State from obligations which it has undertaken by virtue of the Convention for European Economic Co-operation, the Articles of Agreement of the International Monetary Fund, the General Agreement on Tariffs and Trade and other international agreements to which it is a party.

ARTICLE 38

Annexes

The Annexes to this Convention are an integral part of it and are the following:

Annex A.—Basic duties.

Annex B.—Rules regarding Area origin for tariff purposes.

Annex C.—List of Government aids referred to in paragraph 1 of Article 13.

Annex D.—List of agricultural goods referred to in Article 21, paragraph 1.

Annex E.—Fish and other marine products.

Annex F.—List of territories to which paragraph 2 of Article 43 applies.

Annex G.—Special arrangements for Portugal in regard to import duties and quantitative export restrictions.

ARTICLE 39

Ratification

This Convention shall be ratified by the signatory States. The instruments of ratification shall be deposited with the Government of Sweden which shall notify all other signatory States.

ARTICLE 40

Entry into force

This Convention shall enter into force on the deposit of instruments of ratification by all signatory States.

ARTICLE 41

Accession and association

1. Any State may accede to this Convention, provided that the Council decides to approve its accession, on such terms and conditions as may be set out in that decision. The instrument of accession shall be deposited with the Government of Sweden which shall notify all other Member States. This Convention shall enter into force in relation to an acceding State on the date indicated in that decision.

2. The Council may negotiate an agreement between the Member States and any other State, union of States or international organisation, creating an association embodying such reciprocal rights and obligations, common actions and special procedures as may be appropriate. Such an agreement shall be submitted to the Member States for acceptance and shall enter into force provided that it is accepted by all Member States. Instruments of acceptance shall be deposited with the Government of Sweden which shall notify all other Member States.

ARTICLE 42

Withdrawal

Any Member State may withdraw from this Convention provided that it gives twelve months' notice in writing to the Government of Sweden which shall notify all other Member States.

ARTICLE 43

Territorial application

1. In relation to Member States which are signatories, this Convention shall apply to the European territories of Member States and the European territories for whose international relations a Member State is responsible, other than those listed in Annex F.

2. This Convention shall apply to the territories listed in Annex F, if the Member State which is responsible for their international relations so declares at the time of ratification or at any time thereafter.

3. In relation to a Member State which accedes to this Convention in accordance with paragraph 1 of Article 41, this Convention shall apply to the territories specified in the decision approving the accession of that State.

4. Member States recognise that certain Member States may wish to propose at a later date that the application of this Convention should be extended to those of their territories and the territories for whose international relations they are responsible to which it does not already apply, on terms and conditions then to be determined, and that arrangements creating reciprocal rights and obligations in relation to those territories should be established.

5. In that event, in order to give effect to paragraph 4, there shall, in due course, be consultations among all Member States. The Council may decide to approve the terms and conditions in accordance with which the application of this Convention may be extended to those territories and may decide to approve the specific terms and conditions of such arrangements.

6. If a territory, for whose international relations a Member State is responsible and to which this Convention applies, becomes a sovereign State, the provisions of this Convention applicable to that territory shall, if the new State so requests, continue to apply to it. The new State shall have the right to participate in the work of the institutions of the Association and, in agreement with the new State, the Council shall take the decisions necessary for adopting arrangements to give effect to such participation. The Convention shall continue to apply to the new State on this basis either until its participation ceases in the same manner as that provided with regard to a Member State or, if its accession as a Member State is approved in accordance with paragraph 1 of Article 41, until that accession becomes effective.

7. The application of this Convention to any territory pursuant to paragraphs 2, 3 or 5 of this Article may be terminated by the Member State in question provided that it gives twelve months' notice in writing.

8. Declarations and notifications made in accordance with this Article shall be made to the Government of Sweden which shall notify all other Member States.

ARTICLE 44

Amendment

Except where provision for modification is made elsewhere in this Convention, including the Annexes to it, an amendment to the provisions of this Convention shall be submitted to Member States for acceptance if it is approved by decision of the Council, and it shall enter into force provided it is accepted by all Member States. Instruments of acceptance shall be deposited with the Government of Sweden which shall notify all other Member States.

In witness whereof the undersigned, duly authorised thereto, have signed the present Convention.

Done at Stockholm the

day of , 1959, in a single copy in the English and French languages, both texts being equally authentic, which shall be deposited with the Government of Sweden, by which certified copies shall be transmitted to all other signatory and acceding States.

ANNEX A

Basic duties

1. In paragraph 3 of Article 3 and in this Annex, the import duty applied to imports of a product on any date means the rate of duty actually in force and levied on imports of that product on that date. Where, however, specific quantities or consignments are allowed to be imported under a special administrative licensing or control scheme at a rate of duty lower than that otherwise levied on imports of that product, that lower rate shall not be considered to be the duty applied to that product. But where a lower rate of duty is applied unconditionally without quantitative limitation to imports of a product by reason of the purpose for which it is imported, that rate shall be considered to be the duty applied to that product when imported for that purpose.

2. Where, in a Member State, the import duty on any product is temporarily suspended or reduced on 1st January, 1960, that Member State may, at any time before 31st December, 1964, restore the import duty on that product, provided that

- (a) the industry within its territory has committed itself to substantial expenditure on the development of manufacture of the product in question before the date of signature of this Convention; and
- (b) the circumstances are such that it is reasonable to assume that competition affecting that product from other Member States was an essential element in the calculation of the industry in making its investment; and
- (c) either the product is included in a list which has been notified before the date of signature of this Convention, to the other

States signatory to this Convention, or the Council has authorised such restoration by majority decision.

3. A Member State may restore the import duty on a product otherwise than in accordance with paragraph 2 of this Annex, provided it has informed all other Member States at least one month before the duty is to be restored. If, however, during that time or later any other Member State has a practical interest in the product, *i.e.*, that it produces and exports that product in significant quantities and so declares to the Member State which is proposing to restore or has restored the duty, that Member State shall not restore or shall remove that duty. The Council may decide, by majority vote, that a Member State does not have a practical interest in the product.

4. From the date of restoration of a duty in accordance with paragraph 2 or paragraph 3 of this Annex, the duty shall not exceed that permitted under Article 3, on the assumption that the basic duty is the duty which would have been applied on 1st January, 1960, if the duty had not been temporarily suspended or reduced on that date.

5. For Denmark, the basic duty for any product shall be that applied to imports of that product from other Member States on 1st March, 1960.

6. For Norway, the basic duty on each of the following items shall be the rate specified against that item or such lower rate as may be specified at the relevant time in Schedule XIV to the General Agreement on Tariffs and Trade:

<i>Norwegian Tariff</i>		<i>Rate of duty Norwegian Kroner per kg. or ad valorem</i>
<i>number</i>	<i>Product</i>	
24.02 B	Cigars	20:—
24.02 C	Cigarettes	20:—
ex 32.09 C	Varnishes and polishes	12½%
69.12 A1	Articles of faience, not coloured or decorated	22½%, but not less than 0.80
69.12 A2	Articles of faience, coloured or decorated.	22½%, but not less than 1.20
ex 70.13 B	Decorated glassware for table	20%, but not

Norwegian Tariff number	Product	Rate of duty
		Norwegian Kroner per kg. or ad valorem
	and kitchen purposes	less than 2.40
ex 73.17 B	Soil-pipes	15%
ex 73.20	Soil-pipes fittings	15%
85.03 A	Galvanic dry cells weighing up to 180 grams	15%, but not less than 0.55
ex 92.11	Tape-recorders	15%

7. For the United Kingdom, the basic duty shall be 33⅓ percent *ad valorem* for the following products:—

*Brussels nomen-
clature number*

ex 32.05 Synthetic organic dyestuffs (including pigment dyestuffs) other than such dyestuffs dispersed or dissolved in cellulose nitrate (plasticised or not); synthetic organic products of a kind used as luminophores, other than such products consisting of synthetic organic dyestuffs (including pigment dyestuffs) dispersed or dissolved in artificial plastic material; and products of the kind known as optical bleaching agents, substantive to the fibre.

ex 32.09 Synthetic organic dyestuffs in forms or packings of a kind sold by retail.

The provisions of this paragraph will take effect on the understanding that the duty of 33⅓ percent *ad valorem* will be introduced not later than 1st July, 1960.

8. The Council may decide to authorise a Member State to adopt any rate of duty as the basic duty for any product.

9. The provisions of this Annex apply only to duties on imports of goods eligible for Area tariff treatment.

ANNEX B

Rules regarding area origin for tariff purposes

For the purpose of determining the origin of goods under Article 4 and for the application of that Article, the following Rules shall be applied. The Schedules to this Annex are in the English language only.

Rule 1.—Interpretative Provisions

1. "The Area" means the Area of the Association.

2. In determining the place of production of marine products and goods produced therefrom, a vessel of a Member State shall be regarded as part of the territory of that State. In determining the place from which goods have been consigned, marine products taken from the sea or goods produced therefrom at sea shall be regarded as having been consigned from the territory of a Member State if they were taken by or produced in a vessel of a Member State and have been brought direct to the Area.

3. A vessel which is registered shall be regarded as a vessel of the State in which it is registered and of which it flies the flag.

4. "Materials" includes products, parts and components used in the production of the goods.

5. Energy, fuel, plant, machinery and tools used in the production of goods within the Area, and materials used in the maintenance of such plant, machinery and tools, shall be regarded as wholly produced within the Area when determining the origin of those goods.

6. "Produced" in sub-paragraph (c) of paragraph 1 of Article 4 and "a process of production" in paragraph 2 of that Article include the application of any operation or process, with the exception of any operation or process which consists only of one or more of the following:

- (a) packing, wherever the packing materials may have been produced;
- (b) splitting up into lots;
- (c) sorting and grading;
- (d) marking;
- (e) putting up into sets.

7. "Producer" includes a grower and a manufacturer and also a person who supplies his goods otherwise than by sale to another person and to whose order the last process in the course of the manufacture of the goods is applied by that other person.

Rule 2.—Goods wholly produced within the Area

For the purposes of sub-paragraph (a) of paragraph 1 of Article 4, the following are among the products which shall be regarded as wholly produced within the Area:

- (a) mineral products extracted from the ground within the Area;
- (b) vegetable products harvested within the Area;
- (c) live animals born and raised within the Area;

- (d) products obtained within the Area from live animals;
- (e) products obtained by hunting or fishing conducted within the Area;
- (f) marine products taken from the sea by a vessel of a Member State;
- (g) used articles fit only for the recovery of materials, provided that they have been collected from users within the Area;
- (h) scrap and waste resulting from manufacturing operations within the Area;
- (i) goods produced within the Area exclusively from one or both of the following:
 - (1) products within sub-paragraphs (a) to (h);
 - (2) materials containing no element imported from outside the Area or of undetermined origin.

Rule 3.—Application of Percentage Criterion

For the purposes of sub-paragraph (c) of paragraph 1 of Article 4:

- (a) Any materials which meet the conditions specified in sub-paragraph (a) or (b) of paragraph 1 of that Article shall be regarded as containing no element imported from outside the Area;
- (b) The value of any materials which can be identified as having been imported from outside the Area shall be their c.i.f. value accepted by the customs authorities on clearance for home use, or on temporary admission, at the time of last importation into the territory of the Member State where they were used in a process of production, less the amount of any transport costs incurred in transit through the territory of other Member States;
- (c) If the value of any materials imported from outside the Area cannot be determined in accordance with sub-paragraph (b) of this Rule, their value shall be the earliest ascertainable price paid for them in the territory of the Member State where they were used in a process of production;
- (d) If the origin of any materials cannot be determined, such materials shall be deemed to have been imported from outside the Area and their value shall be the earliest ascertainable price paid for them in the territory of the Member State where they were used in a process of production;
- (e) The export price of the goods shall be the price paid or pay-

able for them to the exporter in the territory of the Member State where the goods were produced, that price being adjusted, where necessary, to a f.o.b. or free at frontier basis in that territory;

- (f) The value under sub-paragraphs (b), (c) or (d) or the export price under sub-paragraph (e) of this Rule may be adjusted to correspond with the amount which would have been obtained on a sale in the open market between buyer and seller independent of each other. This amount shall also be taken to be the export price when the goods are not the subject of a sale.

Rule 4.—Unit of Qualification

1. Each article in a consignment shall be considered separately.
2. For the purposes of paragraph 1 of this Rule:
 - (a) where the Brussels Nomenclature specifies that a group, set or assembly of articles is to be classified within a single heading, such a group, set or assembly shall be treated as one article;
 - (b) tools, parts and accessories which are imported with an article, and the price of which is included in that of the article or for which no separate charge is made, shall be considered as forming a whole with the article, provided that they constitute the standard equipment customarily included on the sale of articles of that kind;
 - (c) in cases not within sub-paragraphs (a) and (b), goods shall be treated as a single article if they are so treated for purposes of assessing customs duties by the importing Member State.

3. An unassembled or disassembled article which is imported in more than one consignment because it is not feasible for transport or production reasons to import it in a single consignment shall, if the importer so requests, be treated as one article.

Rule 5.—Segregation of materials

1. For those products or industries where it would be impracticable for the producer physically to segregate materials of similar character but different origin used in the production of goods, such segregation may be replaced by an appropriate accounting system, which ensures that no more goods receive Area tariff treatment than would have been the case if the producer had been able physically to segregate the materials.

2. Any such accounting system shall conform to such conditions

as may be agreed upon by the Member States concerned in order to ensure that adequate control measures will be applied.

Rule 6.—Treatment of mixtures

1. In the case of mixtures, not being groups, sets or assemblies of separable articles dealt with under Rule 4, a Member State may refuse to accept as being of Area origin any product resulting from the mixing together of goods which would qualify as being of Area origin with goods which would not so qualify, if the characteristics of the product as a whole are not essentially different from the characteristics of the goods which have been mixed.

2. In the case of particular products where it is, however, recognised by Member States concerned to be desirable to permit mixing of the kind described in paragraph 1 of this Rule, such products shall be accepted as of Area origin in respect of such part thereof as may be shown to correspond to the quantity of goods of Area origin used in the mixing, subject to such conditions as may be agreed upon.

Rule 7.—Treatment of Packing

1. Where for purposes of assessing customs duties a Member State treats goods separately from their packing, it may also, in respect of its imports from the territory of another Member State, determine separately the origin of such packing.

2. Where paragraph 1 of this Rule is not applied, packing shall be considered as forming a whole with the goods and no part of any packing required for their transport or storage shall be considered as having been imported from outside the Area, when determining the origin of the goods as a whole.

3. For the purpose of paragraph 2 of this Rule, packing with which goods are ordinarily sold by retail shall not be regarded as packing required for the transport or storage of goods.

Rule 8.—Documentary Evidence

1. A claim that goods shall be accepted as eligible for Area tariff treatment shall be supported by appropriate documentary evidence of origin and consignment. The evidence of origin shall consist of either—

- (a) a declaration of origin completed by the last producer of the goods within the Area, together with a supplementary declaration completed by the exporter in cases where the producer is not himself or by his agent the exporter of the goods; or
- (b) a certificate given by a governmental authority or authorised body nominated by the exporting Member State and notified

to the other Member States, together with a supplementary declaration completed by the exporter of the goods.

These declarations, certificates and supplementary declarations shall be in the form prescribed in Schedule IV to this Annex.

2. The exporter may choose either of the forms of evidence referred to in paragraph 1 of this Rule. Nevertheless, the authorities of the country of exportation may require for certain categories of goods that evidence of origin shall be furnished in the form indicated in sub-paragraph (b) of that paragraph.

3. In cases where a certificate of origin is to be supplied by a governmental authority or an authorised body under sub-paragraph (b) of paragraph 1 of this Rule, that authority or body shall obtain a declaration as to the origin of the goods given by the last producer of the goods within the Area. The governmental authority or the authorised body shall satisfy themselves as to the accuracy of the evidence provided; where necessary they shall require the production of additional information, and shall carry out any suitable check. If the authorities of the importing Member State so require, a confidential indication of the producer of the goods shall be given.

4. Nominations of authorised bodies for the purpose of sub-paragraph (b) of paragraph 1 of this Rule, may be withdrawn by the exporting Member State if the need arises. Each Member State shall retain, in regard to its imports, the right of refusing to accept certificates from any authorised body which is shown to have repeatedly issued certificates in an improper manner, but such action shall not be taken without adequate prior notification to the exporting Member State of the grounds for dissatisfaction.

5. In cases where the Member States concerned recognise that it is impracticable for the producer to make the declaration of origin specified in sub-paragraph (a) of paragraph 1 or in paragraph 2 of this Rule, the exporter may make that declaration, in such form as those Member States may for the purpose specify.

Rule 9.—Verification of Evidence of Origin

1. The importing Member State may as necessary require further evidence to support any declaration or certificate of origin furnished under Rule 8.

2. The importing Member State shall not prevent the importer from taking delivery of the goods solely on the grounds that it requires such further evidence, but may require security for any duty or other charge which may be payable.

3. Where, under paragraph 1 of this Rule, a Member State has

required further evidence to be furnished, those concerned in the territory of another Member State shall be free to produce it to a governmental authority or an authorised body of the latter State, who shall, after thorough verification of the evidence, furnish an appropriate report to the importing Member State.

4. Where it is necessary to do so by reason of national legislation, a Member State may prescribe that requests by the authorities of importing Member States for further evidence from those concerned in its territory shall be addressed to a specified governmental authority, who shall after thorough verification of the evidence furnish an appropriate report to the importing Member State.

5. If the importing Member State wishes an investigation to be made into the accuracy of the evidence which it has received, it may make a request to that effect to the other Member State or States concerned.

6. Information obtained under the provisions of this Rule by the importing Member State shall be treated as confidential.

Rule 10.—Sanctions

1. Member States undertake to introduce legislation, making such provision as may be necessary for penalties against persons who, in their territory, furnish or cause to be furnished a document which is untrue in a material particular in support of a claim in another Member State that goods should be accepted as eligible for Area tariff treatment. The penalties applicable shall be similar to those applicable in cases of untrue declarations in regard to payment of duty on imports.

2. A Member State may deal with the offence out of court if it can be more appropriately dealt with by a compromise penalty or similar administrative procedure.

3. A Member State shall be under no obligation to institute or continue court proceedings, or action under paragraph 2 of this Rule,

- (a) if it has not been requested to do so by the importing Member State to which the untrue claim was made; or
- (b) if, on the evidence available, the proceedings would not be justified.

SCHEDULE I

List of qualifying processes with alternative percentage
criterion

SCHEDULE II

List of qualifying processes with no alternative percentage
criterion

SCHEDULE III

Basic materials list

SCHEDULE IV

Forms of documentary evidence of origin

[These Schedules will be published as Cmnd. 906—I]

ANNEX C

List of Government aids referred to in paragraph 1 of
Article 13

(a) Currency retention schemes or any similar practices which involve a bonus on exports or re-exports.

(b) The provision by governments of direct subsidies to exporters.

(c) The remission, calculated in relation to exports, of direct taxes or social welfare charges on industrial or commercial enterprises.

(d) The remission or repayment, in respect of exported goods, of indirect taxes, whether levied at one or several stages, or of charges in connection with importation, to an amount exceeding the amount paid on the same product if sold for internal consumption.

(e) In respect of deliveries by governments or governmental agencies of imported raw materials for export business on different terms than for domestic business, the charging of prices below world prices.

(f) In respect of government export credit guarantees, the charging of premiums at rates which are manifestly inadequate to cover the long-term operating costs and losses of the credit insurance institutions.

(g) The grant by governments (or special institutions controlled by governments) of export credits at rates below those which they have to pay in order to obtain the funds so employed.

(h) The government bearing all or part of the costs incurred by exporters in obtaining credit.

ANNEX D

List of agricultural goods referred to in Article 21,
paragraph 1

<i>No. in the Brussels Nomenclature</i>	<i>Description of Goods</i>
Chapter 1	Live animals
Chapter 2	Meat and edible meat offals <i>except</i> whalemeat * (ex 02.04)
Chapter 4	Dairy produce; birds' eggs; natural honey
Chapter 5	
— 05.04	Guts, bladders and stomachs of animals (other than fish), whole and pieces thereof
ex 05.15	Animal products not elsewhere specified or included <i>except</i> blood powder, blood plasma and salted fish roes unfit for human consumption; dead animals of Chapter 1 or Chapter 3, unfit for human consumption
Chapter 6	Live trees and other plants; bulbs, roots and the like; cut flowers and ornamental foliage
Chapter 7	Edible vegetables and certain roots and tubers
Chapter 8	Edible fruit and nuts; peel of melons or citrus fruit
Chapter 9	Coffee, tea, maté and spices <i>except</i> maté (09.03)
Chapter 10	Cereals
Chapter 11	Products of the milling industry; malt and starches; gluten; inulin
Chapter 12	
— 12.01	Oil seeds and oleaginous fruit, whole or broken
— 12.02	Flours or meals of oil seeds or oleaginous fruit, non-defatted (excluding mustard flour)
— 12.03	Seeds, fruit and spores, of a kind used for sowing
— 12.04	Sugar beet, whole or sliced, fresh, dried or powdered; sugar cane
— 12.05	Chicory roots, fresh or dried, whole or cut, unroasted
— 12.06	Hop cones and lupulin
ex 12.07	Basil, borage, mint (excluding dried peppermint and pennyroyal), rosemary and sage

* Annex E.

- 12.08 Locust beans, fresh or dried, whether or not kibbled or ground, but not further prepared; fruit kernals and other vegetable products of a kind used primarily for human food, not falling within any other heading
- 12.09 Cereal straw and husks, unprepared, or chopped but not otherwise prepared
- 12.10 Mangolds, swedes, fodder roots; hay, lucerne, clover, sainfoin, forage kale, lupines, vetches and similar forage products
- Chapter 13
- ex 13.03 Pectin
- Chapter 15
- 15.01 Lard and other rendered pig fat; rendered poultry fat
- 15.02 Unrendered fats of bovine cattle, sheep or goats; tallow (including "premier jus") produced from those fats
- 15.03 Lard stearin, oleostearin and tallow stearin; lard oil, oleo-oil and tallow oil, not emulsified or mixed or prepared in any way
- 15.06 Other animal oils and fats (including neat's-foot oil and fats from bones or waste)
- 15.07 Fixed vegetable oils, fluid or solid, crude, refined or purified
- ex 15.12 Animal or vegetable fats and oils, hydrogenated, whether or not refined, but not further prepared, *except* those wholly of fish and marine mammals
- 15.13 Margarine, imitation lard and other prepared edible fats
- Chapter 16
- 16.01 Sausages and the like of meat, meat offal or animal blood
- 16.02 Other prepared or preserved meat or meat offal
- ex 16.03 Meat extracts and meat juices, *except* whalemeat extract *
- Chapter 17
- 17.01 Beet sugar and cane sugar, solid
- 17.02 Other sugars; sugar syrups; artificial honey (whether or not mixed with natural honey); caramel

* Annex E.

- 17.03 Molasses, whether or not decolourised
- ex 17.04 Fondant, pastes, creams and similar intermediate products, in bulk, with an added sweetening matter content of 80 percent or more
- 17.05 Flavoured or coloured sugars, syrups and molasses, but not including fruit juices containing added sugar in any proportion

*No. in
the Brussels
Nomenclature*

Description of Goods

Chapter 18

- 18.01 Cocoa beans, whole or broken, raw or roasted
- 18.02 Cocoa shells, husks, skins and waste

Chapter 19

- 19.02 Preparations of flour, starch or malt extract, of a kind used as infant food or for dietetic or culinary purposes, containing less than 50 percent by weight of cocoa
- 19.03 Macaroni, spaghetti and similar products
- 19.04 Tapioca and sago; tapioca and sago substitutes obtained from potato or other starches
- ex 19.07 Bread and ordinary bakers' wares *except* ships' biscuits, crumbs and rusks
- ex 19.08 Pastry and other fine bakers' wares, whether or not containing cocoa in any proportion, *except* biscuits, wafers, rusks, "slab-cake," "sand-cake" and "Danish pastry"

- Chapter 20 Preparations of vegetables, fruit or other parts of plants *except* tomato pulp or paste in airtight containers with a dry weight content of not less than 25 percent tomato, wholly of tomato and water, with or without salt or other preserving, seasoning or flavouring ingredients (ex 20.02)

Chapter 21

- ex 21.06 Pressed yeast
- ex 21.07 Food preparations not elsewhere specified or included, with a substantial content of fats, eggs, milk or cereals *except* ice-cream powder and pudding powder

Chapter 22

- 22.04 Grape must, in fermentation or with fermentation arrested otherwise than by the addition of alcohol
- 22.05 Wine of fresh grapes; grape must with fermentation arrested by the addition of alcohol
- 22.06 Vermouths, and other wines of fresh grapes flavoured with aromatic extracts
- 22.07 Other fermented beverages (for example cider, perry and mead)
- ex 22.09 Ethyl alcohol, undenatured, with an alcohol content of less than 80 degrees; spirituous beverages *except* the following: whisky and other spirits distilled from cereals; rum and other spirits distilled from molasses; aquavit, genever, gin, imitation rum and vodka; alcoholic beverages based on the foregoing spirits; wine brandy and fig brandy; liqueurs and cordials; compound alcoholic preparations (known as "concentrated extracts") for the manufacture of beverages
- 22.10 Vinegar and substitutes for vinegar

Chapter 23

- 23.02 Bran, sharps and other residues derived from the sifting, milling or working of cereals or of leguminous vegetables
- 23.03 Beet pulp, bagasse and other waste of sugar manufacture; brewing and distilling dregs and waste; residues of starch manufacture and similar residues
- 23.04 Oil-cake and other residues (except dregs) resulting from the extraction of vegetable oils
- ex 23.06 Vegetable products of a kind used for animal food, not elsewhere specified or included, *except* seaweed meal
- ex 23.07 Sweetened forage and other preparations of a kind used in animal feeding, *except* fish solubles

Chapter 24

- 24.01 Unmanufactured tobacco; tobacco refuse

Chapter 35

- ex 35.01 Casein, caseinates and other casein derivatives

ANNEX E

Fish and other marine products

<i>No. in the Brussels Nomenclature</i>	<i>Description of Goods</i>
ex 02.04	Whale meat
ex 03.01	Fish, fresh (live or dead) chilled or frozen; except frozen fillets
03.02	Fish, salted, dried or smoked
ex 03.03	Crustaceans and molluscs; except frozen peeled prawns other than Dublin Bay prawns
ex 16.03	Whale meat extract

ANNEX F

List of territories to which paragraph 2 of Article 43 applies

Faeroe Islands
Greenland
Gibraltar
Malta

ANNEX G

Special arrangements for Portugal in regard to import duties and quantitative export restrictions

1. Special arrangements in regard to the reduction and elimination of import duties on certain products imported into Portuguese territory covered by the Convention, and in regard to the application by Portugal of quantitative export restrictions are provided in this Annex.

I

Import duties

2. The provisions in paragraphs 4 to 6 of this Annex shall be substituted for paragraph 2 of Article 3 in relation to any products of which there is production in Portuguese territory covered by the Convention on 1st January, 1960, and which are not referred to in paragraph 3 of this Annex.

3.—(a) The products excepted from paragraph 2 of this Annex are

(i) goods the export of which to foreign countries

amounts to 15 percent or more of the production in Portuguese territory covered by the Convention on the average of the three years ended 31st December, 1958; or

- (ii) other goods notified by Portugal, even though the industries concerned are not exporting industries covered by sub-paragraph (i) of this paragraph.

(b) Before 1st July, 1960, Portugal shall notify to the Council the products to which sub-paragraphs (i) and (ii) of this paragraph will apply.

4.—(a) On and after each of the following dates Portugal shall not apply an import duty on any product referred to in paragraph 2 of this Annex at a level exceeding the percentage of the basic duty specified against that date:

1st July, 1960	80
1st January, 1965	70
1st January, 1967	60
1st January, 1970	50

(b) The Council shall decide before 1st January, 1970, the timetable for the progressive reduction of import duties on such products which remain after that date, provided that those duties shall be eliminated before 1st January, 1980.

5. If on the average of the three years ending 31st December, 1959, or of any subsequent three years before 1st January, 1970, exports of any product to foreign countries amount to 15 percent or more of production in Portuguese territory covered by the Convention, and provided that this level of exports is not due to exceptional circumstances, the elimination of the remaining duty on such products shall be achieved by annual reductions of 10 percent of the basic duty, unless the Council decides otherwise.

6.—(a) Portugal may, at any time before 1st July, 1972, increase the import duty on a product or establish a new import duty on a product not then produced in significant quantities in Portuguese territory covered by the Convention, provided that the import duty so applied

- (i) is necessary to help to promote the development of a specific production; and
- (ii) is not on an *ad valorem* basis higher than the normal level of customs duties applied in the most favoured nation tariff of Portugal at that time to

- similar products produced in Portuguese territory covered by the Convention.

(b) Portugal shall notify to the Council any duty to be applied in accordance with sub-paragraph (a) of this paragraph not less than 30 days before its introduction. If any Member State so requests, the Council shall examine whether the conditions in that paragraph are fulfilled.

(c) Portugal shall, before 1st January, 1980, eliminate import duties applied in accordance with sub-paragraph (a) of this paragraph. Such duties shall be reduced at an even and progressive rate. Portugal shall notify to the Council the programme of reduction to be applied. The Council shall, at the request of any Member State, examine the programme notified, and may decide to modify it.

II

Quantitative export restrictions

7. The provisions of Article II shall not prevent Portugal from applying quantitative restrictions on exports of an exhaustible mining product if, taking into account the quantities of the product available, the supplies necessary for domestic industries would be endangered by the export of such a product to the territories of Member States. Portugal, if it applies restrictions in accordance with this paragraph, shall notify them to the Council, if possible before they come into force, and shall enter into consultations with any Member State concerned.

IV.—PROTOCOL RELATING TO THE APPLICATION OF THE CONVENTION ESTABLISHING THE EUROPEAN FREE TRADE ASSOCIATION TO THE PRINCIPALITY OF LIECHTENSTEIN

The Signatory States of the Convention establishing the European Free Trade Association and the Principality of Liechtenstein,

Considering that the Principality of Liechtenstein forms a customs union with Switzerland pursuant to the Treaty of 29th March, 1923, and that according to that Treaty not all the provisions of the Convention can without further authority be applied to Liechtenstein, and

Considering that the Principality of Liechtenstein has expressed the wish that all the provisions of the Convention should be applied

to it, and, to this end, in so far as this is necessary, proposes to give special powers to Switzerland,

Have agreed as follows:

1. The Convention shall apply to the Principality of Liechtenstein as long as it forms a customs union with Switzerland and Switzerland is a Member of the Association.
2. For the purposes of this Convention, the Principality of Liechtenstein shall be represented by Switzerland.
3. This Protocol shall be ratified by the signatory States. The instruments of ratification shall be deposited with the Government of Sweden which shall notify all other signatory States.
4. This Protocol shall enter into force on the deposit of instruments of ratification by all signatory States.

In witness whereof the undersigned, duly authorised thereto, have signed the present Protocol.

Done at Stockholm, the day of , 1959, in a single copy in the English and French languages, both texts being equally authentic which shall be deposited with the Government of Sweden, by which certified copies shall be transmitted to all other signatory and acceding States.

For the Republic of Austria:

For the Kingdom of Denmark:

For the Principality of Liechtenstein:

For the Kingdom of Norway:

For the Portuguese Republic:

For the Kingdom of Sweden:

For the Swiss Confederation:

For the United Kingdom of Great Britain and Northern Ireland:

V.—NOTE ON PREPARATORY COMMITTEE

When Ministers from Austria, Denmark, Norway, Portugal, Sweden, Switzerland and the United Kingdom met in Stockholm on 19th and 20th November, 1959, to approve the Convention establishing a European Free Trade Association, they decided to set up a Preparatory Committee to deal, before the entry into force of the Convention, with the following matters:

- (1) drafting of rules of procedure of the Council;
- (2) proposals concerning arrangements for the secretariat services of the Association, including the Staff regulations;

- (3) drafting of regulations on financial arrangements necessary for the administrative expenses of the Association, including the procedure for establishing a budget and the apportionment of expenses between the Member States;
- (4) a draft protocol on the legal capacity, privileges and immunities to be granted by the Member States in connection with the Association;
- (5) such other questions in connection with preparations for the establishment of the Association, as the signatory states may agree.

Stockholm, 20th November, 1959.